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STOCKS AND SHARES

BY HARTLEY WITHERS

"I am to speak of what all People are busie about, but not one in Forty understands"

An Essay upon Publick Credit, 1710

LONDON
JOHN MURRAY, ALBEMARLE STREET, W.

FIRST EDITION	*October*, 1910
Reprinted	*January*, 1911
Reprinted	*March*, 1913
Reprinted	*April*, 1914
SECOND EDITION	*March*, 1917
Reprinted	*November*, 1917
Reprinted	*July*, 1919
Reprinted	*March*, 1921
Reprinted	*June*, 1923
Reprinted	*April*, 1926
Reprinted	*July*, 1930
THIRD EDITION	1938

PREFACE TO THE THIRD EDITION

As compared with the Money market, changed out of recognition by the fall of the gold standard, Stocks and Shares have been little altered in the twenty-seven years since this book was written. There is much more of them; and our Government debt has been multiplied by ten, in continuance of the system, noted in chapter VII, of using official borrowing power as a weapon of war. But though enormously increased in number, securities are much the same in form, and are surrounded by much the same mysteries and marketed in much the same way as in 1910.

There have, however, been important improvements in the attitude of the Stock Exchange Committee towards its responsibility to the public, and in the intelligence and care applied by members of the House to the conduct of their business; and a momentous change has occurred in investment policy and habit, owing to better recognition of the safety of ordinary shares, when well chosen and held in sufficient number. These developments are dealt with in a new supplementary chapter.

H. W.

INGATESTONE,
November, 1937.

PREFACE

It is the pleasant privilege of a City journalist to glean among the best brains of the world of finance. It is his daily duty to pass on his gleanings to the readers of his paper, and this book is an endeavour to extend the scope of the process, and to make clearer some of the dark sayings that have to be written and read, day by day, by those who chronicle and follow the movements of securities. To make full acknowledgment of indebtedness, I should have to give a list of all the good friends who inform me concerning the course of the stock markets, and can sometimes be tempted to roam at large over wider fields of financial interest. I owe special thanks to a member of the Stock Exchange, who has read the whole book in proof, and to an auditor who has gone through the two chapters dealing with company accounts.

HARTLEY WITHERS.

September, 1910.

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CHAPTER I

INTRODUCTORY

STOCKS and shares are a matter of interest to all, and of bewilderment to most, of civilized humanity. The interest may be indirect and unrecognized. The salaried official may flatter himself, perhaps, that because he draws an income direct from Government he is beyond the reach of the influence of stock markets and their movements, and need give no heed to their ebullitions and vagaries; but a debauch of riotous speculation, organized in mere lightness of heart by the free-booters of the New York Stock Exchange, may have consequences which will affect the prices of goods which are necessary to his existence. Modern industry is so closely knit by the quickness and cheapness of news and transport, and depends so much for its efficiency on the facilities and conveniences that are given to it by the stock markets, that the ups and downs of Capel Court and Wall

Street have an influence, generally unsuspected by those affected, alike in the palace and the cottage. They go still further, and disturb the repose of nature. A rising market in rubber shares will lead to perturbation and alarm among the birds and beasts of unpenetrated tropical forests, by the sudden appearance of a number of strange, two-legged interlopers, tapping trees, clearing paths, building huts, lighting fires, and otherwise making themselves unpleasant. A syndicate lately formed in London to prospect for doubloons in the ribs of a Spanish galleon, alleged to have been wrecked on the Cornish coast, is inevitably, with its pumping and diving, causing much disturbance and debate among the shrimps and crabs of Dollar Cove.

Bewilderment on the subject of stocks and shares and their prices and fluctuations is nearly as general as their influence. The average unmathematical schoolboy who has struggled through the arithmetic book with the same sort of tolerant disgust that he feels for a French lesson, generally gives the business up in despair when he arrives at "stocks." Hitherto, he will admit, there have been occasional glimmerings of sense in it. Problems about the time that it will take two men to pump out a cistern, or how much it will cost to paper a room, have more or less relation with the facts of life, and may even possess

a certain sordid interest to a utilitarian mind. But these incredible things called stocks, in which folk deal on terms that ought only to be possible in Bedlam, selling £100 stock for £83—"How can it be £100 stock," our young friend will ask, "if you only sell it for £83?"—are matters before which the most intrepid imagination quails. Then there is the commission that always complicates the problem, that beggarly one-eighth per cent. that is so clearly an arithmetical fiction, because no one could possibly live on it, much less keep motors on it as many stockbrokers in real life obviously do—the whole thing is dismissed as a quagmire of foolishness.

Later in life much of this bewilderment generally endures, but side by side with it there has arisen the knowledge that these stocks and shares, whatever they may mean, "go up and down in the City," as Mr. Tony Weller said, making Sam think that he was talking about omnibuses; also that money is to be made if one can find somebody clever and kind enough to tell one which is going up next; that there are many beneficent gentlemen in the world who are prepared to supply this information, apparently out of the mere desire to make every one rich and happy; that there are certain ingenious systems by which it is possible to buy stocks and shares without paying for them, sell them again at a

higher price—if the price does happen to go higher—and pocket the difference with a virtuous feeling of having been really clever, and somehow increased the wealth of the world. Hence many folk speculate, and most of them are subsequently sorry. Those who have saved or inherited money possess investments, concerning the nature and meaning of which they are often—perhaps generally—quite ignorant, until the discovery that something is wrong with one or two of them produces a conviction that the purchase or possession of securities is a matter which requires at least as much attention as the stocking and care of a wine cellar. Moreover, in these days the high level of taxation and the high standard of ostentation and extravagance are making everybody anxious to invest in the most profitable manner possible, many old-fashioned conventions, which used to guide our ancestors in their choice of securities, have been thrown into the dust-bin, and the investing public takes a more intelligent interest in its investments than it has ever done before. This interest is all to the good if it makes the investor critical rather than greedy, and as long as it does not blind him to the fact that good expert advice is above all things necessary in this complicated and technical business. A good stockbroker is the first requirement of a judicious investor. But the investor may save his broker

and himself a great deal of trouble, and also may be able to appreciate and use his broker's advice to much better purpose if he knows something about marketable securities, what they are and what they mean, how they came into being, what are their most notable merits and defects, how and why they go up and down in price, and how much can fairly be expected from them The object of this volume is to attempt some explanation of these matters, and this chapter will endeavour to show how stocks and shares came into being.

Stocks and shares, as dealt in on the Stock Exchanges of the world, fall into two main classes. They represent either (1) the debts of Governments, municipalities and other public bodies, or (2) the debts and capitals of joint stock companies. If you buy a bit of the debt of any Government or company, you become its creditor, and it has to pay you interest at stated intervals, and sometimes promises to pay you some day the principal sum represented by the security. If you buy a bit of the capital of a company you become one of the proprietors of its business, entitled to a share in its profits.

Public debts and joint stock companies are thus the primary causes which produce stocks and shares, and the product will be made clearer if we look back over the development of the causes, the history of which is both interesting and curious.

They are both comparatively modern inventions, and public debts are in fact a complete reversal of ancient practice. There was a time when a well-ordered State, instead of being normally in debt, was possessed of a treasure, which it amassed in times of peace and prosperity to stand it in good stead when need arose. The examples of the wealth heaped up by Pericles in the Acropolis at Athens, and the treasure in the temple of Saturn at Rome which was forcibly taken by Caesar in the teeth of the protest of a tribune of the people, are examples known to every schoolboy. It may be that our Treasury, that Government department which now regulates and handles the British revenue and manages the British debt, owes its name to the fact that a locker full of monetary shot was once part of the furniture of Government. Now it is the fashion for Governments and municipalities and all other public bodies incorporate to possess a more or less extended list of debts. Just as the ship's company, wrecked on a desert island, and eager to return thanks to Heaven for its preservation, could think of no other religious formula than the passing round of a hat, so all modern Governments are agreed in this one respect of being continually in debt.

The change arose gradually and imperceptibly. In the Middle Ages kings seem to have alternated between the possession of hoarded resources and

chronic indebtedness, according to the circumstances of their reigns and the bent of their own temperaments. Thrifty monarchs who did not happen to be engaged in ruinous wars acquired assets. Expensive ones with a taste for display, a band of rapacious favourites or a thirst for military glory, acquired liabilities. If these liabilities became too pressing and could not be met by the comparatively respectable methods of debasing the currency or forced grants, there was nothing for it but repudiation. It is rather astonishing to find royal gentlemen, in other respects patterns of knightly honour, submitting to a composition with their creditors apparently with all the resignation shown under similar circumstances by a Central American Republic. Richard Coeur de Lion, the kingly knight-errant who vied with Saladin in chivalry, went even further than repudiating debt. He sold certain assets of the crown, and subsequently took them back again, on the ground that he had had no right to alienate them.

The monarchical system made the debts of the mediaeval kings to a certain extent a personal matter. It is recorded that Edward the Third, on retiring into Flanders at the end of a fruitless campaign against Philip of France, found that "he had contracted near £300,000 of debt; he had anticipated all his revenue; he had pawned everything of value that belonged either to himself or to his queen; he

was obliged in some measure even to pawn himself to his creditors, by not sailing to England till he obtained their permission, and by promising, on his word of honour, to return in person, if he did not remit their money." * This king broke his faith with Florentine bankers, a fact of which, as Thorold Rogers † has related, their descendants are still mindful, and in his reign, a debt of Edward the First to certain towns of Aquitaine, for goods supplied to his troops, was "discharged," the Mayor of London and another compounding with the creditors for about half the sum claimed as due, and then "going on the Southampton custom." ‡

"Going on the Southampton custom" meant receiving a charge on the customs of the port for the interest and redemption of the loan. In the Middle Ages, the kingly borrowings were generally arranged with alien financiers, who received these charges on the foreign trade of the country, which again was largely in alien hands; and under these circumstances piracy and smuggling came to be regarded by the men of those days as almost a patriotic duty.

Foreign monarchs broke faith with their creditors even more readily and often than the English sovereigns. Taine records that French

* Hume, "History of England," ch. xv.

† "Economic Interpretation of History," ch. xx.

‡ "The King's Customs," Atton and Holland, ch. ii.

debts were dishonoured no less than fifty-six times between the time of Henry the Fourth and the Revolution. The most impudent and wholesale repudiation was that effected by Philip the Second of Spain, the king who is of interest to Englishmen as having sent the Armada to be wrecked on our shores. He contrived to give an air of saintly purpose to his default, and the terms in which, in 1596, he revoked all the assignments, mortgages, and deeds by which his revenues and domains had been charged, are a brilliant gem in the literature of royal bankruptcy, all the more brilliant, perhaps, from being probably quite sincere. This pious enthusiast complains that "notwithstanding all which our royal incomes from this monarchy and from without have yielded; together with the assistance rendered to us by His Holiness to maintain the war against the English, and to protect the Catholic religion; . . . and besides the great abundance of the gold and silver produced by our Indies; . . . we find ourselves now wholly exhausted and ruined. . . . And now the said merchants, who hitherto have given on bills of exchange such monies as were necessary to provide for the protection of our royal state and to carry on the war which we are waging for these righteous and special reasons, refuse to do this any longer . . . and hereby such embarrassments arise, that if they are not provided against, it would be enough

to put in hazard all that which God the Lord has so highly commanded us to perform, namely the protection and maintenance of the Catholic Church, of our subjects and vassals, and all those who dwell under our Government."

"Therefore to put an end to such financiering and unhallowed practices with bills of exchange, which have been introduced and have spread abroad among so many people, who, in order to follow such pursuits, have abandoned agriculture, cattle raising, mechanical works, and embarked in trade, finding therein gain and profit to the disservice of the Lord God and of us. . . . We have now given command to devise some means of restoring order, and of accomplishing in the best possible way that which we are so highly and legally bound to do, whereupon hang the protection of Christendom and the security of our realms; and we have found no other remedy than to call in and to disburthen our royal incomes, liberating the same from the unjust damage put upon them through this financiering and bills of exchange. . . . Having decided to cancel and annihilate all the aforesaid interests and impositions, we shall afterwards meditate upon ways and means by which may be paid to the merchants and traders what may seem to us properly due to them. . . . Accordingly, we suspend and declare suspended all such assignations made by us in any manner whatsoever since

September 1, 1575, and December 1, 1577, unto this date."

Perhaps the most perfect passage in this statement is the reference to the melancholy spectacle of those who have forsaken the honest pursuits of agriculture and industry and taken to the trade of finance, "to the disservice of the Lord God and of us," the saintly writer implying that by ruining all these financiers he would be sending them back to pursuits which would be more beneficial to the community. The result of this proclamation is described in Motley's "United Netherlands," ch. xxxiii., whence the above extracts are quoted. "The chief merchants and bankers of Europe suspended payment. Their creditors become bankrupt. . . . There was a general howl of indignation and despair upon every exchange, in every counting room, in every palace, in every cottage of Christendom."

After this striking example, the action of our own Charles the Second in stealing £1,328,526 deposited in the Exchequer by the goldsmiths, who were in his day the bankers, of London, was a comparatively mild effort; but it is interesting in two respects. It was a potent cause of the City's Whiggish enthusiasm which induced it later to support the government of William and Mary, and found the Bank of England for its financial support. It was also connected with the beginnings

of our national debt, in the truly national sense. "The half of this sum was acknowledged by Parliament as a national obligation, and it forms, in origin at least, the oldest part of the public debt, though it was not formally recognized till 1701." *

Being thus adopted, as to one half, by the representatives of the nation, this repudiated debt of Charles the Second's forms a link between the old personal debts of the absolute monarchs of the Middle Ages, and the national debts acknowledged by popular representatives and a liability of the nation as a whole, which are now so important a part of the stocks and shares held by modern investors and gambled in by modern speculators.

Between these monarchical and national debts there are two important distinctions. The former were, from the necessities of the case, ostensibly at least raised for a short period, to provide for an emergency and to be repaid or repudiated when it had passed; and they were negotiated with bankers and merchants, who had no investing public to whom they could pass it on, no Stock Exchange in which they could sell it. There was, of course, a certain amount of trafficking and dealing in the King's promises to pay, and a very pretty example is recorded in history. When King Edward the Third was in his dotage, two of the bright spirits

* Thorold Rogers, "The First Nine Years of the Bank of England," ch. i.

who adorned his Privy Council—one a Peer, the other a wealthy London merchant—"bought up some of the King's debts from his despairing creditors at an immense discount. They then took advantage of their position on the Council Board to pay themselves out of the impoverished exchequer to the full amount of the original liability."* But there was no free market in the modern sense of the phrase. National loans are now offered by general subscription to a public accustomed to investing their savings in this manner, and are launched and floated by means of a cunning system devised by the highest financial skill. When floated, the stock representing the loans can always be readily turned into cash through the machinery of the Stock Exchange, and to all appearance these public issues of national obligations are in some respects an even greater convenience to the investing and stockjobbing classes than to the Government which is borrowing. In fact, any national or municipal borrower of to-day, that is blessed with a reasonably good reputation for meeting its obligations, is able, by playing off the loanmongers of one centre against another, to put itself in the position of granting a benefit to the group or banking house to which it finally entrusts the business The manufacture of credit has been so skilfully worked out that the borrower, instead of

* G. M. Trevelyan, "England in the Age of Wycliffe."

going cap in hand to the lender, frequently conducts an informal auction in which the right of raising a loan for him goes to the lender who will promise to float it at the highest price. This is only so at times when the monetary machine is working easily, and these periods so pleasant to the borrower are sometimes broken by seasons during which he finds every pocket closed against him.

These periods of monetary famine are comparatively rare. As a rule, the borrower is welcomed with open arms and can almost dictate his own terms, and sometimes the eagerness of moneylenders is so great that the borrower is practically compelled to borrow more than he wants. In 1909, China wanted a loan for the building of a railway, and after much haggling and diplomacy the privilege of lending her the money had been divided among a group of English, French, and German financiers. Then a claim was made by the United States Government, which considered that American bankers ought to be allowed to take part in the business, and it was decided that the best way out of the difficulty was for China to borrow more than she required so that the loan might be made big enough to give American bankers a share, without depriving the other bankers of the amount which they thought to be their due. But negotiations and arguments

concerning the loan were still proceeding when this book went to press.

In 1907, the American Government was itself compelled to borrow money that it did not want, but for a different reason The currency system of the United States at that time forbade the banks to issue notes except against Government security, and owing to a monetary famine more notes were wanted. And so the Government had to raise a loan that it did not at all want, to give the banks more Government securities as a backing for more notes.

Thus by the development of a loan issuing machinery and of Stock Exchanges in which the securities representing the loans can be dealt in at prices which are regularly published, the ability of any country or municipality to raise vast loans and leave the payment of them to posterity has been made temptingly easy. The process is comfortable to the borrower, profitable to the financiers who handle the loans, and a boon to the investing classes, and if the sums so raised are well spent, is a very valuable convenience to the community as a whole. Contrariwise, if they are ill-spent on unprofitable enterprises, they tend to become a heavy load. Whether posterity will submit for all time to bearing a burden, that seems likely to grow with the centuries, handed down to it often by the mere financial incompetence of its

ancestors is a question which, if ever it is practically raised, can only be answered by posterity. At present, it can at least be said that the doleful prophecies of England's ruin, to be wrought by the huge load of debt that was thrown on her shoulders by the Napoleonic wars, have not come true; but it must be remembered that they might perhaps have been fulfilled, had it not been for the great industrial development of the last century. The modern system which encourages Governments and municipalities to meet their needs by bills drawn on posterity, contains seeds of possible disaster, the sprouting of which has to be carefully watched for and checked.

There seems to be some doubt as to which Government first hit on this happy device for filling its exchequer. Thorold Rogers * claims the distinction for his beloved Dutchmen who, he considers, invented it during the course of their heroic struggle against Spain which lasted from 1572 to 1609. But a passage in Blackstone's "Commentaries," bk. i. ch. viii., shows that the city of Florence anticipated the Dutchmen by a few centuries. Florentine bankers did much of the financing of the Middle Ages, and as we have seen above, wrote off a bad debt from Edward the Third. Florence struck the first gold piece † of modern

* "Economic Interpretation of History," ch. xx.

† Shaw, "History of Currency."

coinages, and can claim to have made the first public issue of marketable securities. The system of public borrowing, says Blackstone, "seems to have had its original in the State of Florence, A.D. 1344; which Government then owed about £600,000 sterling, and, being unable to pay it, formed the principal into an aggregate sum, called metaphorically a mount or bank, the shares whereof were transferable like our stocks, with interest at 5 per cent., the prices varying according to the exigencies of the State." Here we have, in the Florence of the fourteenth century, a security, the exact counterpart of a modern Government obligation, divided into shares or bonds, dealt in, in what must have been something like a modern market, at prices which moved with the political and financial conditions of the moment.

In England stocks with a public market were not heard of until the end of the seventeenth century, when the necessities of William the Third's Government led his ministers to introduce the system which his Dutch ancestors had found useful a hundred years earlier. It was preceded by a device which brings us face to face with the second class of the securities which form the stocks and shares of to-day, namely the capitals of joint stock companies. As everybody knows, the Bank of England was formed to lend the whole of its capital to William's Government. The amount

originally involved was £1,200,000, a sum which looks paltry enough in these days, and the rate of interest paid by the Government was no less than 8 per cent. Here we have a step which marks the progress from a Government's borrowing from a few individual merchants, and a Government issue to a stock-dealing public. In this case, the Government borrows from a company incorporated for this purpose, and the company makes a public issue of its stock, which is offered to investors at large and becomes a marketable security.

In the case of the Bank, this is a quite reasonable proposition, for it is the business of a bank to lend or invest its capital, and it is enabled to do some of its lending by handing its notes, or promises to pay, to the borrower. Thus the Bank of England made part of the advance to the Government, which was the cause of its foundation, in the shape of bills drawn on itself.* But it is remarkable to find that other companies, which might have been expected to require their capital for the purposes of their own business, went into this seemingly irrelevant trade of financing the Government. The irrelevance is only seeming, for by lending to the Government they obtained some monopoly or privilege, without which it was then believed that a company could

* Thorold Rogers, "Fust Nine Years of the Bank of England," ch. I.

not live. For example, the South Sea company, which made such a stir in the world that it has become the standing instance of bad joint stock finance ending in panic, in the early part of the eighteenth century carried out a consolidation of the Government debt, lending more than thirty-three millions—a huge sum in those days—to the Government. It is cited by Adam Smith as an instructive example of the "folly, negligence, and profusion" to be expected from a joint stock company, and he pithily remarks that "the knavery and extravagance of their stock-jobbing projects are sufficiently known, and the explication of them would be foreign to the present subject."* Under the treaty of Utrecht, signed in 1713, the monopoly of shipping slaves to the Spanish colonies in America was transferred from France to England. Lecky remarks that "to those who care to note the landmarks of moral history . . . it may not be uninteresting to observe that among the few parts of the peace of Utrecht which appear to have given unqualified and unanimous satisfaction at home was the Assiento contract, which made England the great slave-trader of the world. The last prelate who took a leading part in English politics affixed his signature to the treaty. A *Te Deum*, composed by Handel, was sung in thanksgiving in the churches."†

* "Wealth of Nations," bk. v. ch. l.

† "History of England," ch. l.

This was less than two centuries ago, and yet wiseacres still tell us, that human nature cannot be changed. The slave monopoly was worked by the South Sea Company, which lost money by it. "Their ill-success," says Adam Smith, "was imputed, by their factors and agents, to the extortion and oppression of the Spanish Government; but was, perhaps, principally owing to the profusion and depredations of those very factors and agents; some of whom are said to have acquired great fortunes even in one year."

Another of the early companies which combined the business of trade with that of financing the Government was the East India Company. The first company of this name was established by a charter of Queen Elizabeth in 1600. Originally, it was one that was known as a "regulated" company, that is, it was a mere association of merchants, possessing a joint monopoly of a certain trade, which each member worked for his own profit. But in 1612, the members "united into a joint stock," and became a joint stock concern, worked for the common benefit of the stockholders. Their first chairman was a retired buccaneer, and an Earl. Since their charter had never been confirmed by Parliament, there was some doubt about its validity, and "in 1698 a proposal was made to Parliament of advancing two millions to Government at eight per cent., provided the subscribers

were erected into a new East India Company with exclusive privileges. The old East India Company offered seven hundred thousand pounds, nearly the amount of their capital, at four per cent. upon the same conditions. But such was at the time the state of public credit, that it was more convenient for Government to borrow two millions at eight per cent. than seven hundred thousand pounds at four. The proposal of the new subscribers was accepted, and a new East India Company established in consequence." * The marvellous career of this company is a matter of general history, and is one of the most astonishing combinations to be found in its pages of glorious and beneficent achievement, with venality, peculation, and rapacity. Its misdeeds in India are chronicled in Burke's lurid periods. At home its representatives shocked even the eighteenth century's sense of decency by the profligate profusion with which they carried on bribery and corruption. But it built up the Indian Empire.

It is interesting to note that among the regulated and joint stock companies which Adam Smith examines in his chapter on the subject, the Hudson's Bay Company is almost the only one which he admits to have traded with any success, though he considers that its profits had been greatly exaggerated. He remarks that this company's

* "Wealth of Nations," *loc cit.*

"moderate capital . . . may be sufficient to enable them to engross the whole, or almost the whole, trade and surplus produce of the miserable, though extensive, country comprehended within their charter. . . . Over and above all this, the moderate capital of this company is said to be divided among a very small number of proprietors. But a joint stock company, consisting of a small number of proprietors, with a moderate capital, approaches very nearly to the nature of a private co-partnery, and may be capable of nearly the same degree of vigilance and attention." *

Whatever the cause of its success, the Hudson's Bay Company, or the Governor and Company of Adventurers of England trading into Hudson's Bay, as it is fully entitled, not only survives to the present day, but has lately received much public attention owing to the growing wealth of what Adam Smith described as its "miserable though extensive country" through the waxing prosperity of Canada. It is not only the oldest but one of the lustiest of existing joint stock companies. Founded in 1670, twenty-four years before the Bank of England, it made its appearance in the pages of history in 1685, when the great commercial companies vied with municipalities, inns of court, grand juries, and the universities of Oxford and Cambridge in expressing obsequious servility to James the Second

* "Wealth of Nations," bk. v. ch. i.

on his accession to the throne. Macaulay * relates that "all the great commercial societies, the East India Company, the African Company, the Turkey Company, the Muscovy Company, the Hudson's Bay Company, the Maryland Merchants, the Jamaica Merchants, the Merchant Adventurers declared that they most cheerfully complied with the royal edict which required them still to pay custom." This edict had no Parliamentary sanction, and the Hudson's Bay Company is the sole survivor of the companies which expressed their approval of it.

Such were the shadowy and questionable beginnings of the joint stock companies which have changed the character of modern business, and whose securities supply the great majority of the stocks and shares in which the modern public gambles and invests. A company in the sense in which we are now using it may be described as an organization by which a large number of people subscribe money to a venture from which they hope to earn profits; it is distinguished from a partnership by the fact that its management is entrusted to a committee, called the Board of Directors, and officials appointed for the purpose, whereas that of a partnership is generally in the hands of all the members; by the fact that the members are liable only to the extent of the shares held by them, whereas that of the

* "History of England," ch. iv.

partners in a firm is usually unlimited; and by the fact that a shareholder in a company can, except in a few special cases, transfer his shares to any buyer whom he can find, but cannot make any demand upon the company in respect to them, unless the company is being wound up; whereas a member of a partnership cannot transfer his share in it to any outsider without the consent of his partners, but, on the other hand, can usually call on his partners to pay him his share in the assets of the business when the period of the partnership has expired.

In both of them—joint stock companies and private partnership—the principle holds good, that all share in the profit or loss resulting from the business, according to the amount of their stake in it. Herein they both differ essentially from the regulated companies which appear to have been the forerunners of joint stock companies, and were mere associations of merchants engaged in a common trade, formed to protect the interests of the trade and to prevent interlopers, who were not members of the association, from engaging in the enterprise in which it claimed a monopoly.

These regulated companies seem to have been very similar in character and object to the craft gilds of the mediaeval towns, and may easily have arisen from an application of their principles to foreign trade. The evolution of a regulated company into a joint stock concern would proceed

very naturally. It has been shown that the original East India Company began life as a regulated company, and after twelve seasons' work "founded itself upon a joint stock." It is easy enough to suppose that, with the rough and ready book-keeping of those days, the task of settling the claims of the company against the members, and of the members against the company and one another, must have been complicated and difficult, and the notion must have occurred to some unconscious maker of an economic epoch, that the whole business would be made much simpler if all the members of the association clubbed their capitals, and took a share in the company in proportion to the amount paid into the common stock; the concern being henceforward worked in the interest of all, and its profits being shared in proportion to the amount of capital contributed by each stockholder. The monopoly enjoyed by the band of merchants gathered under the regulated company would then be passed on to the joint stock concern. This fact of monopoly, then thought essential to the success of a joint stock company, probably accounts for the slowness with which the new departure grew, and the unpopularity and suspicion which its growth aroused.

When monopoly, as a necessary asset of a joint stock company, had been abandoned, certain

other drawbacks still produced mistrust of joint stock methods among many of the early critics of the system, and still produce it to this day. Adam Smith, with his long-sighted mental eye, discerned that there were some kinds of enterprise in which a joint stock company was specially qualified to succeed. These were banking, insurance, "navigable cuts and canals" and waterworks. With regard to banking his opinion, which was contrary to that of most bankers in England in his time and later, has been emphatically endorsed by subsequent history; and the large amount of capital required by canals and waterworks made it essential that they should be undertaken by joint stock enterprise in the days before national or municipal ownership had been dreamt of. But his strong individualism made him doubt concerning the possibility of its thriving in other branches. "Without a monopoly," he says, "a joint stock company, it would appear from experience, cannot long carry on any branch of foreign trade. To buy in one market, in order to sell, with profit, in another, when there are many competitors in both; to watch over, not only the occasional variations in the demand, but the much greater and more frequent variations in the competition, or in the supply which that demand is likely to get from other people, and to suit with dexterity and judgment both the quantity and quality of each

assortment of goods to all these circumstances, is a species of warfare of which the operations are continually changing, and which can scarce ever be conducted successfully, without such an unremitting exertion of vigilance and attention, as cannot long be expected from the directors of a joint stock company." * Elsewhere he states that "negligence and profusion must always prevail, more or less, in the affairs of a joint stock company."

J. R. M'Culloch, another sturdy economic Scot, who had the advantage of later experience than Smith, is even more stoutly convinced that joint stock enterprise is doomed to failure, except in certain special undertakings. He also draws a line between companies "whose businesses may be conducted according to a nearly uniform system—such as dock, canal, railway, insurance and banking companies—and those whose business does not admit of being reduced to any regular plan, and where much must be left to the sagacity and enterprise of those employed. All purely commercial companies, trading upon a joint stock, belong to the latter class. Not one of them has ever been able to withstand the competition of private adventurers; they cannot subject the agents they employ to buy and sell commodities in distant countries to any effectual responsibility; and from this circumstance, and

* "Wealth of Nations," bk. v. ch. I.

the abuses that usually insinuate themselves into every department of their management, no such company has ever succeeded, unless when it has obtained some exclusive privilege, or been protected from competition."* He quotes with evident satisfaction a tract published in 1769 by the Abbé Morellet, giving a list of fifty-five joint stock companies, engaged in various branches of foreign trade, "established in different parts of Europe subsequently to 1600, every one of which had failed, though most of them had exclusive privileges." And, he adds, that most of those that have been established since the publication of Morellet's tract have had a similar fate.

These defects inherent in the nature of joint stock enterprise are real enough, if somewhat exaggerated by these ancient authorities, who associated it with monopoly, and feared that it would tend to check the freedom of competition, which was the corner stone of their economic ideal. The difficulty of getting able and diligent directors, and of finding managers who will put the same amount of energy into the work of a company that is provided by an "adventurer" working for his own hand, has only been partially overcome. That it has been overcome at all is due to the higher level of general business probity that rules to-day, and to the gradual creation of a

* "Dictionary of Commerce."

class of salaried officials, continually promoted from the ranks to the management of joint stock companies, with a fine tradition of work for their service, and well rewarded when they reach the top of the ladder.

Without this evolution, modern industry would have been impossible, for the gigantic scale of its operations requires capital so vast that they could not have been undertaken by individual enterprise. Thus the needs of commerce have compelled the creation of a machinery which works with a good deal of jarring, and plenty of loss and failure in individual cases, but well enough on the whole, though its most striking successes are still won in the fields which Smith and M'Culloch marked out as specially favourable to its efforts. The joint stock system has immeasurably quickened the pace of all kinds of commercial and industrial development. It is obviously easier to induce investors to subscribe part of their fortunes to an enterprise, from which they hope to reap dividends earned by their paid representatives, than to find adventurers who will give their whole attention and capital to its exploitation. The profits thereby earned may not be quite so great as they might have been under private management, but they are earned without exertion or responsibility on the part of the proprietors, and without the necessity for

providing capital on the part of their servants and officials. And the introduction of the principle of limited liability has enabled the investor to secure himself against losing more than he risks in any one company, whereas members of a private partnership were, and still are in most cases, liable to the extent of all their possessions if misfortune brought their business to ruin.

This limitation of liability is comparatively modern. In old days when each company that proposed to launch itself had to obtain a Royal Charter or an Act of Parliament, it was sometimes enacted that its members should only be liable to the extent of their stakes in the association. But in 1844 an Act was passed which simplified the creation of new companies, and in 1855 another one made it the rule that the liability of their shareholders should be limited. That is to say, that if any one subscribed £100 of the capital of a new company, or bought stock or shares representing £100 of the capital of an old one, there should be no further claim on him from the creditors of the concern, if its career happened to end in disaster. This principle was further expanded and regulated by the Joint Stock Companies' Acts of 1862—4, and the limitation of liability has had a very great effect in quickening the readiness of investors to place their savings in all kinds of joint stock enterprise. By means of the joint stock

system, far-seeing folk with plenty of ideas and little money are able to get subscriptions for their ideas from those who have funds to invest, and so the material resources of the world have been incalculably increased. Sometimes the ideas do not pay, and the subscribers to them are saddened; but, in the meantime, Continents have been covered with railways, oceans have been crowded with steamships, and most of the habitable globe has been joined together into one humming hive of industry.

CHAPTER II

THE FORMS OF SECURITIES

In an inquiry of this kind, which is meant chiefly to explain matters of common interest concerning which a clear understanding is uncommon, the greatest difficulty is to know where to begin. It is impossible to explain everything at once. A kind friend who tried to read a book on "The Meaning of Money," in which I endeavoured to throw light on some of the dark places of the money market, gave up the task on page 7 because I there used the phrase "discounting a bill" without explaining what discounting meant, and what a bill was. Both these things were made as clear as I could make them later on, but that was not admitted as an excuse. In this book I am trying to turn the flank of this difficulty by means of a Glossary. Now the question is, whether it is better to get a clear idea concerning the forms of securities, or to deal first in detail with the companies and their capitals, and the Governments and their debts which create the securities? It is a new form of the old

question whether the hen comes before the egg, or the egg before the hen. Whichever plan is followed, somebody will think it was the wrong one; but since stocks and shares are the things which probably first affect the consciousness of most of us, and the companies and Governments behind them are generally grasped by a further effort, it is perhaps safer to take this natural order, and deal first with the forms of the securities handled by the stock markets.

Stocks, shares, and bonds are the chief items among these forms, and all three of them, according to the perplexing habit of business nomenclature which seems to go out of its way to be unscientific and confusing, are commonly referred to as stocks. The word stock has meant many things in the course of its versatile career. From a trunk of a tree it was by a natural metaphor applied to the original line of a family. From meaning a log, it was easily applied to a fool—"Let's be no stoicks nor no stocks." With different derivations it signified a cravat and a pass in fencing; and it gradually came to mean something heaped up like a stack or stook, and so some sort of accumulated store. In this sense it still survives in the phrases "stock-in-trade," meaning the goods on hand held by a manufacturing or trading company, and "taking stock," meaning the process of counting and valuing the stock-in-trade. A passage in Bacon

however, shows that he used it as a store of bullion. "Let the exportation of home commodities," he says in his Advice to Villiers, "be more in value than the importation of foreign, and the stock of the kingdom shall yearly increase; for then the balance of trade must be returned in money or bullion." Doubtless it was in this sense of a store of money that Ben Jonson used it—"Prodigal men feel not their own stock wasting." From this sense the transition was easy to the meaning in which the word is generally used by Adam Smith, namely, the capital * of a firm or company, that is to say, the monetary resources which have been invested in its business or kept in hand for its daily needs. Proceeding in its evolution the word transferred its meaning to the securities received by those who subscribed the capital of companies, and then divided itself again to mean marketable securities in general, and a certain kind of marketable security in particular.

In its general sense it is applied to all the securities dealt in on the Stock Exchange. For instance, money articles sometimes tell us that Kaffirs were dull with a slight decline, but little stock came to market, although the capitals of the South African mines dealt in in this market are

* In America the word stock has kept this meaning of the capital of a company, and the stock is divided into shares, usually of $100. But there also shares are often spoken of as stocks.

expressed not in stock but in shares; and a stock broker means a man who will buy and sell for you stocks, shares, or bonds.

In its particular sense, stock is distinguished from shares by being divisible into, and transferable in, odd and varying amounts, ranging from tens of thousands down to a penny in some cases, and £1 in many or £5 or £10 in some. This distinction is difficult to grasp and express, and is best illuminated by a concrete example. Let us take the case of a company with a capital of £100,000 in stock, originally offered at par, that is, £100 stock for £100 money. When it first invites subscriptions from the public, any one who writes for £5000 or £75, or £23, or any such "broken" amount as the Stock Exchange calls it, may expect to have his application accepted and to have a corresponding amount of stock credited to him in the company's books, receiving from it a certificate to that effect. The stock will be quoted in the Stock Exchange at so much per £100 stock. If the company prospers exceedingly, and pays a 10 per cent. dividend, the price of the stock may rise to £200, and then the holder of £23 of stock will be able to sell his stock at 200, thus obtaining £46 for it. If it has fared ill and the price has fallen to 50, he will be only able to get £11 10s. for it. But it is a common delusion that because stock is quoted at so much per £100 it can only

be transferred from seller to buyer in hundreds. This is not so. Its distinguishing feature, which divides it from shares and bonds, is this fact that it can be split up into any odd amount—£527 or £5291 being transferable in a block. But it should be noted that these broken amounts are less easy to deal in in the stock market, where the most readily negotiable amounts of stock are in thousands or five hundreds from £1000 to £10,000, with smaller parcels moderately marketable, and so on. Thus, if you wish to buy or sell stock, you will do so most easily if you buy a round thousand or a multiple of a thousand, or of £500. If you have a fairly large amount with a broken bit attached, such as £2674, you will deal easily enough, but if it be £674 your broker might have to make some concession in the matter of price.

Another distinction between stock, in its strict and particular sense, and other securities lies in the fact that stock is always registered or inscribed, while shares and bonds may be what are called "bearer" securities. We have seen above that the original subscriber to an issue of stock receives from the issuing company a certificate to the effect that he is a holder of so much stock in its books, that is, that he has been registered as such. This certificate is not in itself "evidence of title," as the lawyers say. Its possession does not constitute ownership. It is merely a memorandum from

the company acknowledging the fact that the party therein named is a holder of so much stock. If you hold such a certificate and wish to transfer your stock it will not be enough to pass this certificate on to the buyer. The sale has to be completed by a deed of transfer, which will be described more fully in a later chapter, to which your certificate will be attached; when this transfer deed is exhibited to the company, it will register your buyer as a holder of the stock, give him a new certificate and destroy yours.

Although the certificate does not by itself constitute an actual title to the stock mentioned in it, it is usual for companies to stipulate that they will not register any transfer of the stock without the production of the certificate, and if the certificate be lost, its replacement by a new one may be a matter of some difficulty and expense.

In the case of inscribed stock, the holder is given what is called a stock receipt, which is merely an acknowledgment that his name has been inscribed among the list of stockholders. It has no value or importance, and there is no need to produce it if the holder wishes to transfer his stock to another party. Inscribed stock can only be transferred by the personal attendance of the holder at the office where the list of stockholders is kept, or by the attendance of some one legally entitled to act as his attorney in the matter

The difference between registered and inscribed stock is thus one of detail. The essential point in the nature of both is that holders of the stock are put down in a list kept by the company, or by a bank authorized to keep it, and receive their dividends in regular course by post, either at their own address, or sent direct to their bankers, if they so arrange. If they wish to sell it they have to execute a deed of transfer in the case of registered stock, or in that of inscribed stock to attend, in person or by attorney, and sign a document transferring the stock to the buyer. This is the point which distinguishes both registered and inscribed stocks from "bearer" securities. Holders of the latter are not entered in a list, but are given documents which constitute, in themselves, evidence of possession. Stock, as we have seen, is always either registered or inscribed, whereas shares can be either registered or to bearer.

Whether registered or to bearer, shares are distinguished from stock by being expressed in definite amounts, and indivisible.* We supposed above, by way of example, a case of a company with a capital of £100,000 expressed in stock, and it was shown that this stock could be divided up into any fragments that individual investors might

* Usually, but some few companies will transfer fractions of their shares.

choose to apply for originally, or to deal in afterwards. If this capital were expressed in shares, the shares would be definitely described as of £1 or £10, or whatever their denomination might be. Original applicants would subscribe for so many shares, subsequent purchasers would buy so many shares, and the market price would be so much per share. Thus the market price of stock is expressed by the current quotation for £100 of stock, and the market price of shares is the current quotation per share. For example, if the price of London and North Western Railway stock is 136, this expression means that any buyer of £1000 of the company's stock pays £1360 for it, this being the rate at which the higgling of the market decides that those who wish to become proprietors in the enterprise can at the present moment induce sellers to part with their holding. If any news arrived which made the company's prospects more favourable the price might rise to 137, and the buyer of £1000 stock would have to pay £1370 for it. The capital of the Chartered Company of British South Africa is in £1 shares, and when they are quoted at 1¾, any one who wished to acquire £1000 of its capital would buy 1000 shares and pay £1750 for them.

We have seen that stock, in this particular sense, is always registered or inscribed, while shares may be either registered, or to bearer. If

they are registered, their holders are in the same position as holders of stock, that is, they are enrolled in the company's books, receive their dividends by post without any trouble in going to ask for them, and hold a certificate which states that they are holders of so many shares, but is not in itself an absolute title to possession. That is to say, if handed to some one else, it does not thereby make him the owner of the shares. If they are bearer securities, the holder is not enrolled in the books of the company, but receives from the company if an original subscriber, or from his seller if a subsequent buyer, a document which is in itself proof that the holder of it is a proprietor of so many shares in the company. Hence they are called "bearer" securities, because the bearer of them is from the fact of possessing them the owner of part of the company's capital to the extent named in the document, or scrip as it is commonly called.

This arrangement has drawbacks and advantages. The chief drawback is the fact that if you own bearer shares and lose them, or have them stolen, your evidence of title is gone. There is no record in the company's books to show that you have ever been a shareholder, and if the shares are sold you cannot recover them from the new holder, unless you can prove, which is extremely difficult, that he bought them knowing them to have been

stolen. It follows that a holder of bearer securities has to be very careful of their safety and, if he is wise, will put them in charge of his banker. Another drawback is connected with the dividends that may become due to holders. Since the company has no record of their names and addresses, it is impossible for it to send out dividend cheques by post as is done in the case of registered holders. It can only pay dividends on presentation to it of what are called coupons or "cuttings," namely fragments of the bearer certificates, which always have a certain number of these coupons attached, to be cut off and presented when a dividend is declared These coupons have to be taken to the office of the company, which generally requires three clear days for the examination of them, to see that they are genuine and in order, after this period it will pay the sum due This tiresome process is undertaken by bankers for such of their customers as leave bearer securities in their charge, and the investor is thus able to shift the trouble involved by the difficulty of collection of dividends on bearer securities on to other shoulders, and the keen competition among bankers of to-day enables him to do so without making any payment.

Against these drawbacks, the necessity for great care in the preservation of a bearer's share, and the troublesome process of gathering its

dividends—both of which can be thrown on the broad shoulders of a banker—we can set great advantages. Bearer securities can be handled and transferred much more easily and cheaply, and can be borrowed on much more readily, and this latter convenience is looked upon as a great benefit in these spendthrift days, when both nations and individuals seem to think that any assets that they may own are wasted unless pledged. If you want to sell bearer shares there is no troublesome ceremony to be gone through with a transfer deed and a certification process. You deliver the scrip to your buyer, or rather your broker does it for you, and your buyer and his expert representatives having satisfied themselves that it is in order, give you a cheque for the amount due. And again when you want to borrow, your bearer securities are, or should be, in the hands of your banker already. All that is needed is that he, instead of holding them in safe custody on your account, should be authorized to hold them as a pledge against the sum borrowed. The trouble and expense of a transfer deed are again avoided, and as the occasion of a transfer deed is one of the many opportunities seized by the Chancellor of the Exchequer for putting his hand in your pocket, its expense is a consideration not to be ignored.

Hitherto the greater safety of registered

securities and the simple system by which dividends are paid on them have made them the more popular form of investment with the English public. Trustees who have to invest the funds of their trusts according to the strict letter of the Trustees' Acts, cannot hold bearer securities; and even when the drafting of the trust deeds allow them to do so, they are generally very loth to avail themselves of this power, owing to the liability involved by the danger of the loss or theft of the securities. But there has been a great change in recent years in the English attitude on this point. The advantages carried by bearer securities in themselves have gradually worn down the wall of British prejudice, and the fact that Continental holders and dealers greatly prefer them has given them another advantage, the benefit of which is very great. The quickness and cheapness of telegraphic and telephonic communication have knit the chief stock markets of the world into one, and a security thus has a great advantage which can be bought and sold not only in London, but in Paris, Berlin, Amsterdam, and other centres where the cravings of Continental capitalists for investments are satisfied. Owing to Continental habit, this advantage can only be enjoyed by bearer securities, and where it is desired to create an international market, it is now the general practice to give the security the bearer

form, or at least to give its holders the choice of either being registered, or holding bearer securities, as they may choose.

It has long been a custom among many Continental investors to hold English Consols, a habit which is believed to have grown out of the freedom of this island from invasion, and its greater political security, as demonstrated in 1848, when all the capitals of Europe were in a condition of more or less revolution and disturbance, while London went about its business as usual. To meet the convenience of these Continental holders arrangements have for many years been in existence by which holders of Consols can change their stock into bearer scrip with coupons attached. A similar power is occasionally clamoured for in the case of Home Railway stocks, and it is contended that if holders of these securities could have the option of being registered or receiving bearer certificates, the market would be made much freer, and carry-over operations (a matter which must be left for explanation later on) and pledging business would be greatly simplified and cheapened. Hitherto the Home Railway Boards have shown themselves less ready to move with the times than the Treasury, and the want of bearer certificates may be one of the causes which for a long time almost killed speculation in the Home Railway market.

The capitals of most of the South African mining companies, in which foreign operators are particularly fond of investing and gambling, nearly all carry the right of being held either by registered holders or in the shape of bearer scrip. For speculative purposes bearer securities have a further advantage besides the cheapness and ease with which they can be transferred and pawned. This lies in the fact that it is impossible to trace operations in them, and large operators, who prefer to cover the tracks of their dealings, sometimes find this secrecy a convenience. Any large alteration in the holdings of registered stocks and shares can easily be traced by inspection of the register at Somerset House, which is open to any one who cares to pay a fee of one shilling, and inquisitive financial journalists sometimes put very interesting information before their readers by this method, showing who has been unloading, or how much stock has been registered in the names of bank managers, with the obvious inference that it has been pawned, and has not yet found a real holder. This high light of publicity is often galling to a certain class of financiers, in whom modesty and a craving for half-tones and shaded lamps are strongly developed, and they are able to secure a pleasant and restful twilight by the use of bearer certificates, the movements of which from one hand to another, and in and out of bankers' tin

boxes, are nowhere recorded in a manner which is accessible to the curious.

American practice has devised an ingenious compromise by which the advantages of bearer and registered securities are more or less combined. Holders of the common stocks of most of the American railroad and industrial companies are registered as such, and are given a certificate stating they are so registered. On the back of this certificate is a form of assignment, of which the following example is taken from a certificate of the Illinois Central Railroad :—

KNOW ALL MEN BY THESE PRESENTS that .... for value received ha...... bargained, sold, assigned and transferred, and by these presents do...... bargain, sell, assign and transfer unto .... of .... (   ) Shares of the Capital Stock of the Illinois Central Railroad Company, represented by the within Certificate, on which have been paid One hundred Dollars on each share standing in .... name on the books of said Company, and transferable only at the office mentioned in this Certificate. And .... do... hereby constitute and appoint .... true and lawful Attorney, irrevocable for .... and in .... name and stead, but to .... use, to sell, assign, transfer and set over, all or any part of the said Stock, and for that purpose to make and execute all necessary acts of assignment and transfer, and one or more persons to substitute with like full power, hereby ratifying and confirming all that .... said Attorney or .... substitute or substitutes shall lawfully do by virtue hereof.

IN WITNESS WHEREOF, ... hereunto set ....

hand and seal the .... day of . . ..
One thousand nine hundred

....

Sealed and delivered in the
presence of

....

When this form has been signed by the holder named on the face of the certificate, the certificate becomes practically a bearer security and any one who holds it can fill his own name in and so complete the transfer to himself. Thousands of American railroad shares change hands with all the ease and simplicity of bearer securities in this fashion. The dividends are paid to the registered holder, and are from him collected by the possessor of the certificate or his agent.

After stocks and shares we come to bonds and debentures. Bonds and debentures are nearly always to bearer, but may sometimes be registered; debenture stocks are, of course, always registered. Bonds and debentures resemble shares by being always expressed and transferred in a fixed amount, but are unlike shares in that these amounts often vary in the bonds of one issue, to meet the convenience of all classes of subscribers and buyers. For instance, when the Argentine loan of 1907 was issued, the prospectus stated that the bonds were to bearer, and were in denominations of £20, £100, £200, and £1000. The small denominations are for the use of the small

capitalist who invests in small amounts, the large ones are for plutocratic private investors, and for banks, insurance companies, and trust companies, which handle large sums, and, if they put £20,000 into a certain security, do not want to have to house a stack of scrip, and cut off innumerable coupons whenever an interest date arrives. Apart from these varying denominations, bonds cannot be divided, and they thus differ from stock, of which, as we said, a block of any size can be transferred, and odd amounts can be marketed, though not as freely as even lots. The distinctive feature of a bond is that it always implies a debt. The word is naturally associated with Shylock, and this association gives the true key to its meaning. Shylock made a very unfortunate investment, because, owing to the slipshod drawing of the deed he was cheated out of his bargain by a piece of Old Bailey chicanery on the part of Portia. But even Shylock could have had his money if he had not been so hungry for the flesh of his enemy ; and most bondholders, being in the position of creditors, not proprietors, are able to enforce their claims, in the majority of cases, or put their debtors into liquidation, a last indignity which any joint stock company is extremely reluctant to undergo.

As this distinction between a creditor and a proprietor is one of great importance, it is worth

while to make its full significance clear at once, though by doing so it will be necessary to take certain expressions for granted, that will be explained more fully in the next chapter, which will deal with the classes of securities, as distinguished from their forms. Any one who holds ordinary and preference stock or shares in a company is thereby one of its proprietors, a part owner of the property. His position is thus similar to that of a partner in a brewery or factory, except that he has delegated the management to a committee called the Directors, and the officials of the company. If the concern flourishes he takes his dividends and is as thankful as the habit of mind of the average stockholder allows. If, on the other hand, misfortune dogs the footsteps of the company, he has to go without dividends, very probably sees his preferential rights—if a preference stockholder—invaded and impaired, and will have no comfort except the plausible regrets and explanations of the Chairman, which become all the more plausible, and all the less convincing, as the fortunes of the company sink deeper. If anything like fraud is suspected, he can, if he be very energetic and prepared to spend something on an attempt to get justice which will probably cost him more than it brings in, get together a committee of his fellow shareholders and set on foot a Board of Trade inquiry, and, perhaps, a prosecution, which

will probably be good for nobody but lawyers. If it be merely a question of mismanagement, his only remedy will be the very empty gratification of grumbling in the columns of the financial press, and airing his sorrows at the company's meetings. Here the practised platitudes of the Chairman will overwhelm him—"The Directors themselves are the greatest sufferers owing to their substantial stake in the concern; Mr. Carper's interest, fortunately for him, is limited to £200; the Board feels the greatest sympathy with those whose investments have been hitherto unfortunate; it is confident that a brighter day is about to dawn on the company's fortunes; the Board has devoted an enormous amount of time and trouble to the difficult problems involved by the company's affairs; will most willingly resign their responsibility into other hands if Mr. Carper has any definite suggestions to bring forward," and so on. Mr. Carper leaves the meeting abashed, silenced, and more dissatisfied than ever.

Mr. Shylock the bondholder is, or should be, in a much stronger position. Much depends on the terms of the bond, and on the trust deed which ought to secure it, but, in any case, he—and the holder of debentures and debenture stock is similarly fortified—is not a proprietor but a creditor. If the interest on his bonds is not forthcoming, he has, or ought to have, trustees specially appointed

to act on his behalf and to put the company into the hands of a receiver, or even to foreclose on it, that is say, to seize it and sell it up stock, lock, and barrel. Their right to do so will depend on the terms of the trust deed, but in any case the claims of creditors to interest are a very different matter from the desires of proprietors for dividends. If the creditors are not met, the company is eclipsed financially and probably dies, and with it die also the Directors' fees, the solicitors' and auditors remuneration, and the officials' salaries, all of which can continue as usual, and ought to do so, though the shareholders may be receiving nothing. So that the incentive that urges those responsible for a company's conduct to meet the claims of creditors is nothing else than that strongest of all natural influences which impels us all to try to keep ourselves alive.

So far a bond has been considered as a debt of a company. But most of the bonds dealt in on the Stock Exchange are debts of Governments and municipalities. In their case the incentive that urges the debtor to meet their service is different, but perhaps, on the whole, quite as strong. There is no question here of a legal process by which the creditors' representatives will be able to seize the debtor's goods and collect his revenues. In some few cases, such as those of the Chinese Maritime Customs and certain items of the Greek revenue,

imposts on which loans are charged are handed to the bondholders' representatives; and in the dark days of Argentine finance, the advantage of a special charge of this kind was shown by the 1886 loan, which received its interest throughout. But even here, if these imposts did not bring in enough to meet the service of the loans, there is no international court before which the defaulting debtor could be haled, and the bondholders would certainly be unable to prevail on their own Government to go to war in order to enforce their claims. The bondholder can only rely on the good faith and self-interest of the debtor, and the latter is generally enlightened enough to know that if he plays fast and loose with one creditor he will find it very difficult to discover another. And since the borrowing habit has now taken a firm hold of all Governments and municipalities they have to be above all things careful to make it clear that, whatever happens, they will meet their obligations if they possibly can. It may also be added that most of them would be impelled to do so by a nobler motive, namely, the sense of collective responsibility felt by the community, and its honest desire to pay its way.

In spite of all the protection given to the holder of a bond, or debt, as opposed to the mere proprietors of a company, who have to take the rough with the smooth in the ups and downs of its

fortunes, it must not be supposed that anything called a bond is necessarily a real security to be invested in without further inquiry. Plenty of bondholders have found out that the property by which their security was alleged to be covered was imaginary or worthless, and financial history has several examples to show of default by states and municipalities. Like all other economic matters this is essentially a question of degree. It is most unsafe to say that a bond or a debenture is necessarily a sound investment, but it is quite safe to say that a bond or debenture, issued under a properly drawn trust deed and with real assets behind it, puts its possessor into a more secure position than the holding of ordinary stocks and shares, which give him merely the right to partake of the prosperity or misfortune of the company whose capital they represent. At the same time the bond lessens the risk of its holder to fluctuations in his income at the expense of his chance of seeing it grow. However great the prosperity of a company, the bondholder is only entitled to his pound of flesh. The greater prosperity improves the value of his security, and enables him to sleep more peacefully, but puts not a penny more income into his pocket. As compared with the speculative attraction of ordinary stocks and shares, the bond or debenture stock is solid rather than brilliant. But the investor who prefers the solid to the brilliant

is in ninety-nine cases out of a hundred justified by results. This disquisition is somewhat irrelevant in a chapter on the forms of securities, and anticipates the discussion of their classes and precedences. But the appearance of the bond among the forms of securities brought us face to face with the great distinction between those which represent debts, of companies or communities, and those which represent the capitals of companies, and so give their holder the position of a proprietor rather than a creditor; and it was important to drive home at the earliest possible moment the fact that a creditor is, as a general rule, in a more secure position than a proprietor. As is always the case in questions of practical economics, it is impossible to say even so much without being faced by a host of exceptions, and it is perhaps safer to state the obvious platitude—lest we be accused of ignoring it—that a creditor of a rotten company is not so well secured as a proprietor in a sound one.

Gathering up the threads of this chapter, we may describe it as having dealt with the forms or outward appearance of the securities dealt in on the Stock Exchange. Divided on this principle they consist of stock, which is transferable in any amount, and shares and bonds or debentures which are always expressed in certain definite multiples—a £5 share, a £20 bond and so on. It was also

shown that stock, as such, is always registered or inscribed, while shares may be registered in the name of holders or may consist of bearer scrip, the possession of which constitutes the title of the holder. Bonds are nearly always bearer securities, but are occasionally registered, and a bond necessarily implies debt. Shares are always portions of a company's capital, while stock may represent either capital or debt. The distinction between capital and debt will be made more clear in the next chapter. It should be added that the word scrip, which also has crept in before it was fully explained, is used in two senses. As a rule, it means any form of bearer security, as opposed to registered stock or shares, and in this sense it was used above. But it also has a special sense of a bearer certificate given to subscribers to a new issue of stock or bonds, pending the preparation of the certificates and bonds which ultimately represent it.

CHAPTER III

COMPANIES' CAPITALS AND THE CLASSES OF SECURITIES

LEAVING on one side for the time being the large class of securities that consist of public debts, we will go on to consider those which are produced by the formation of joint stock companies. Something has been said in Chapter I. concerning the early history of joint stock enterprise, and it is easy to see how companies of this kind must have grown, as a natural development, out of the system by which traders and producers formed themselves into partnerships and syndicates for the handling of an enterprise which was too big for them to tackle by themselves. Partnerships and syndicates are as old as industry. Jacob and Laban are an early enough example in agriculture, and when we come down to Athenian times we find a regular system under which the State leased the silver mines of Laurium to be worked by rich citizens and companies.* Nicias, a general famous for his wealth, piety, and incompetence, had a large

* Grote, "History of Greece," Pt. II. ch. xxxix.

interest in these mines, and kept a private soothsayer to advise him with regard to his mining operations.* The royalties from the silver mines were an important item in the revenues of Athens, and appear to have been from time to time divided among the citizens. Herodotus † tells us that Themistocles persuaded them to forgo a big dividend to which they were entitled, and devote the proceeds to building two hundred ships. Thus the foundations of the greatness of Athens as a sea power were laid, and the means were created for the policy of aggressive expansion, which finally led to its undermining.

From the partnership or syndicate made up of a few members all more or less engaged in the management of the concern, it is a short step to the joint stock company, whose capital is owned by a large number of shareholders, by whom the management is made over to a Board of Directors and paid officers. The step is short, but very important, and it often alters the whole character of the business. Most of the shareholders have, probably, no knowledge whatever of the difficulties and needs of the enterprise; they have invested in it because somebody told them that it was a good thing, or have inherited shares in it, and never troubled to inquire whether it was, or was not, judicious to keep them. Some of the Directors

* Plutarch, "Life of Nicias." † Book VII. ch. cxliv.

are, perhaps, equally ignorant, but most Boards contain a leaven of knowledge and understanding, and their real business is generally done by a small minority, who save the rest from the consequences of their inexperience. Moreover, they generally have a happy capacity for choosing reasonably good men for the actual management of the business, which is done by salaried officers, and on the whole it must be admitted that the joint stock system works fairly well and much better than it might be expected to do as a matter of theory.

In actual practice, the notion that the Board is a committee chosen by the shareholders to supervise the conduct of the business in their interests, is found to be a delusion. The Board forms itself, or is formed by a promoter, before the company asks the public for subscriptions, and remains in office subject to purely formal confirmation by the shareholders; when a vacancy occurs the Board chooses itself a new member, and his appointment is, as a matter of ceremony, confirmed by the proprietors. The officers are chosen by the Board, or by one another, and joint stock companies are thus governed, in practical fact, by a self-elected oligarchy, which is liable, in extreme cases of mismanagement or misfortune, to be turned out by a revolt among the proprietors. As a general rule, the shareholder is

merely a necessary appendage who provides the capital, takes his dividends when he can get them, and has even less voice in the management of the company than the average elector has in the conduct of the Foreign Office. Probably it is just as well that this should be so, but it leaves luck and fortune an extremely free hand in the guidance of joint stock affairs. None of the shareholders, except a select few who are allowed to go behind the scenes, know who are the guiding spirits in the management of their property. They can see the names of the Directors on the published reports, but are probably quite unable to divide the deadheads from the real rulers. They listen to the Chairman's speech, or probably prefer to read it in a paper which the company sends to them, but they do not know who writes it. The really important question about a joint stock company, namely the question as to who actually manages its business and watches over its financial policy, is always a mystery to the outside public, which can only judge roughly by results concerning its position and prospects. These results it is apt to gauge by the dividend paid, which is often a most misleading test, and its judgment is likely to be complicated by some wholly irrelevant consideration, like the reason which was in former years often given for the affection of investors for Home Railway stocks,

namely, the fact that there the railways were, that the proprietors could go and look at their stations and lines and rolling stock, and that their property "could not run away." Whether the earning power could run away did not seem to be a factor in the calculation. As a rule, the shareholder is a sleeping partner, who occasionally stirs in his sleep and delivers himself of more or less relevant utterances at meetings. If he tried to exercise more direct control the effect would probably be disastrous. All that he can do is to put as much trust as he can in the collective wisdom of a self-elected committee, concerning the personalities and abilities of which he knows little or nothing.

How little the main body of the proprietors counts among the facts of a company's position will be seen more clearly if we trace the formation of a company from its beginning.

Joint stock companies are formed either for the exploitation of a new enterprise or to acquire an established business; or they may occasionally be a combination of these two classes, formed to acquire an industry and extend it. The creation of a new enterprise is necessarily a matter of more or less hazard, and it is seldom that the securities of companies formed for this perilous work can be regarded, when first offered, as a serious investment. In their appeal to the public for subscriptions they must needs rely on estimates

concerning their probable earning power, and all the care and caution in the world cannot suffice to draw a line between estimates and guess work. If the new company proposes to build a railway, the number of folk who will travel on it can only be guessed at; if it aims at working a new patent or manufacturing a specially seductive and scientifically saponaceous soap, there is not only a doubt about the number of people who will buy the product, but there is also in most cases a good deal of uncertainty concerning the cost of its production. The difference between the early experiments on which the estimates are based and the actual result achieved when the factory has been built, and work has been started on a commercial scale, nearly always shows that company promoting optimism has a bad head for figures.

Let us take the case of a pioneer who has discovered a really first-rate tooth-powder. We will call him Mr. Cleanbite and imagine that he lives in Brixton and has a small practice as a dentist in Finsbury Circus. His practice has given him the technical knowledge which tells him what tooth-powder ought to be, but has not supplied him with the capital for making it on a large scale. One of his business neighbours in Finsbury Circus is a certain Mr. Mortimer—Mordecai is the name under which his birth was actually registered—who

carries on the mysterious profession of company promoter, underwriter, financier, and organizer of syndicates, with a little semi-amateur advertising agency. Fortune smites Mortimer one chilly March morning with a raging pain in the third molar on the left side of his jaw, and drives him into Cleanbite's lair.

In the course of his investigations Cleanbite infers that the tooth-powder employed by Mortimer might be improved on, and gives him the prescription for his own, and so the train is laid. The powder delights the promoter and stirs his business instincts. The next interview between the pair is across a luncheon table in a well-known City restaurant and Mortimer is proposing to buy outright the dentist's rights in the manufacture of the tooth-powder. Cleanbite is flustered but firm. He has read "Tono-Bungay" and sees visions of millions. He will not sell outright, but is quite prepared to deal on terms which will retain for him an interest in the enterprise, and he refuses to be definite, or to name figures, until he has consulted his brother-in-law, a clerk in a solicitor's office.

Inventor and promoter thus being brought together, business proceeds rapidly along lines thoroughly familiar to the latter. An agreement is soon arrived at with the help of the dentist's brother-in-law, a memorandum of association is

drawn up empowering the company to do nearly everything under the sun, stating that its name is the Hygienic Tooth-powder Company, Limited, that the liability of the members is limited and that the following persons are desirous of being formed into a company in pursuance of the memorandum. These persons are seven in number, and consist of friends and relatives of the enterprising parties, and they all attest their intention to subscribe for one share in the company. The wide powers taken by the memorandum of association do not indicate that the authors of the enterprise have decided to widen its scope beyond the original object of tooth-powder making; they are merely designed to leave the company quite unrestricted in its operations, so that if, for example, it wished to build a fleet of steamers to convey its product to the uttermost ends of the earth, it should not find itself debarred from doing so by any modesty in the original expression of its intentions. The memorandum of association deals with the objects of the company, and its articles of association lay down certain rules by which its conduct will be regulated in formal matters such as the holding of meetings, auditing of accounts, etc. When these preliminary documents have been duly prepared and the stamps paid by means of which the Treasury takes toll of every joint stock company before it is permitted to be born, the company

can be formally registered at Somerset House and receives its certificate of incorporation which gives it its legal and corporate existence.

In the meantime Mortimer has also been busy with the more interesting side of the preliminary spadework. He has been approaching Directors, and pulling mysterious strings designed to set the public thinking about its teeth. Fortune favours him by an accident, which rouses deep interest and concern in all classes of society, to a front tooth of a lady in the front row of the chorus at the Gaiety, and a paper read by a distinguished Fellow of the Royal Society on the Connection between Dental Degeneracy and the Spread of Socialism. A popular newspaper opens its columns to a correspondence headed "Are Teeth Necessary?" which at first gives a welcome chance to advocates of liquid breakfast foods, but is gradually brought round to an overwhelming concensus of evidence in favour of the view that teeth are, on the whole, the most important members of the human anatomy. One of the brightest pens in Fleet Street, lately seduced from the prosaic path of leader-writing and reviewing to the freer and more imaginative atmosphere of advertisement literature, is in the meantime engaged on a series of what are known as "write up" articles dealing with the question of tooth-powder, beginning with the Babylonian period and the Third Egyptian dynasty, with a remarkable

analysis of the favourite powder used by Sesostris the Nineteenth, of which a sample, by some happy chance, was found in his mummy case. By the time that the writer has arrived at the Augustan age and the evidence of Horace's Satires, Mortimer has got his Directors together, and on the very day when the prospectus is ready, the final article of the series makes its timely appearance, demonstrating that the last word in tooth-powders has been uttered by the Hygienic Tooth-powder Company.

The question of Directors had presented some difficulty, because Cleanbite, with a healthy middle-class prejudice, had tried hard to insist on the ornamentation of the Board by the presence of one or two Peers. But Mortimer knew better. "That bait won't do nowadays," he had said with brutal frankness. "You frighten the public if you have too much gilding on the front page. Directors have got to be practical. Tooth-powder wants doctors and dentists and scientific experts. Not that they're practical, but they're what the dear old public thinks it means when it talks about a practical Board. It thinks, that if a man knows what a tooth-powder ought to be made of, he knows how to run a company to make it. We've got to meet its little prejudices and give it a nice scientific Board with a business man as chairman to take care of them."

How Mortimer got the Board together is a

mystery which he would never solve, but there is reason to believe that he did so chiefly by flattering eminent scientists with the subtle insinuation that they had really been designed, not for scientists, but for Captains of Industry, and that great as had been their triumphs in the laboratory their prowess in the busy chaffering marts of commerce would have been even more amazing. Nothing pleases the average mortal more than an assurance that his abilities would have qualified him to do something else much better. It gives him such a comfortable sense of completeness and versatility. Convince a curate that he would have made a capital buccaneer, and he will break most of the commandments for you. A man of science, persuaded that his first-rate abilities for the practical work of the world are wasted for lack of outlet, is as wax in the hands of the persuader.

With copious use of this subtle insinuation, assisted by his curious power of shouldering himself through obstacles that would daunt a Yellow Journalist, Mortimer succeeds in getting together what he calls a really first-rate team of Directors, knowing among them all that is to be known concerning the functions and pathology of teeth, and completely ignorant of all questions of buying, manufacturing, distributing, and selling. The practical side of the business is entrusted to a member of the strange race of professional chairmen

who have been brought into being by the necessities of joint stock enterprise. Having organized a great drapery combination, and reconstructed a water-logged Brewery company with eminent success, Mr. Morples, who is a distant relative of Mortimer, has lately turned his attention to the finance of catering. The connection between teeth and catering is obvious enough to make his presence on the Board appear not too irrelevant to the public, which is nevertheless rather inclined to regard him as an "ornamental" Director, though he is in fact the only one who is likely to be of the smallest use, except as a lure to attract subscriptions. Morples, of course, knows the man for manager, and secures an option for the Hygienic Tooth-powder Company enabling it to buy, on ridiculously reasonable terms, a building which his rehabilitated Brewery had designed for a Kursaal, and can be converted with practically no expense into a factory for the preparation of Hygienic tooth-powder, now duly protected by a patent, which is testified to by eminent counsel as watertight at every point.

So all is at last arranged, and a prospectus makes its glittering appearance, announcing the formation of the Hygienic Tooth-powder Company, Ltd., with a capital of £300,000 in 150,000 6 per cent. cumulative preference shares of £1, and 150,000 ordinary shares of £1. There is also £100,000 5 per cent. 1st Mortgage Debenture stock, redeemable

in 1950 at 105, and repayable at 105 in the case of the voluntary liquidation of the company for amalgamation or any other purpose. Subscriptions are invited for the whole of the Debenture stock and preference shares, and for 100,000 of the ordinary shares. The balance of the ordinary shares are taken by the vendor of the patent, this being the largest amount that he can retain, without sacrificing the possibility of obtaining a quotation for the shares from the Committee of the Stock Exchange, which insists on at least two-thirds being offered to the public. The Debenture stock will be secured by a first mortgage on the freehold site and buildings to be acquired by the company under the valuable option, above mentioned, on the derelict shell of the Kursaal, also by a floating charge on all the assets of the company. The prospectus refers to the many evidences recently accumulated of the importance of sound teeth, and of the overwhelming necessity, for all who wish to secure this first requirement of physical and moral perfection, of the use of Hygienic Tooth-powder. It gives a number of flaming testimonials from *prime donne* who cannot sing without it, down to professional golfers who find that there is nothing like it for steadiness on the putting green. It estimates that out of the forty millions of inhabitants of these islands, at least two millions ought to be converted to its use. With a profit of only

ninepence per annum per user — though very careful estimates of the cost of advertising and production make an annual profit of 1*s.* 6*d.* per consumer practically certain—the company will be in a position, after providing for Debenture interest and sinking fund, and dividend on the preference shares, to pay a dividend of 20 per cent. on the ordinary shares and still retain nearly £30,000 a year for the accumulation of a reserve fund, bonuses to the Directors and officials, and any other purposes that may seem desirable. A leading firm of surveyors has estimated the value of the site and buildings at £131,209 17*s.* 1*d.*, and the company acquires an option giving it the right to buy them at £110,000. For this option it pays the chairman £5000, and he consequently joins the Board after allotment. The cost of the necessary alterations is estimated at £10,000, and that of the necessary machinery at £20,000, and the purchase consideration payable to the holder of the patent is £200,000 payable as to £50,000 in shares, and the balance in cash or shares at the option of the Directors. After the purchase of the patent, site, factory, and machinery, the company will have £55,000 in hand as working capital, an amount which the Directors consider to be amply sufficient. The preliminary expenses of the company, up to and including registration, will be paid by the vendor. Those to which the

company will be liable are guaranteed not to exceed £6000.

It is a most alluring document, and flutters into millions of letter boxes, and spreads itself over the pages of newspapers in treble column advertisements with a success that the careful preparations made for it have fully justified. These careful preparations, however, have been extremely costly, and have all to be met out of the purchase consideration to the vendor which, as we saw above, was £200,000. The large amount of this price, given for a chemical formula of which the commercial value is still problematical, rouses the critical acerbity of certain financial writers, who point out when the prospectus appears that the whole concern is a mere speculation, and that the public is being asked to pay much too much for the chance of losing its money. Poor Cleanbite feels quite guilty for a time under these criticisms, but is soon reassured when he finds how very little of the purchase consideration finds its way into his pocket. Mortimer takes his share, of course, but by far the greater part of the whole amount has gone in advertising, direct and indirect, acknowledged and unacknowledged, and in the various measures taken in order to rouse the interest of the public in the question of teeth and tooth-powder. Underwriters have had to be provided, who will for a consideration of 10 per cent. promise to take up and

pay for any of the securities offered to the public which the public has not taken. Then there is a market to be made. That is to say, arrangements have to be devised for getting the shares dealt in on the Stock Exchange and quoted in the papers. Shares have to be bought to support the market at times when the speculative nature of the undertaking has struck the public more strongly than the testimonials and the names of the "practical" men of science on the Board. When all the necessary expenses of all these necessary arrangements have been met, Cleanbite finds himself, like Clive, astonished at his own moderation as he ruefully contemplates the difference between the amount of the purchase price payable to him on paper, and its net sum when finally in his hands.

Mortimer, better versed in the mysteries of such matters, assures him that he has not done at all badly, and that it has been quite a good flotation; that you cannot make an omelette without breaking eggs and that, after all, "it's the public that pays."

This is true, and is a point to be remembered when we are considering the prospects of any company which requires much preliminary expenditure, as all companies must which undertake to work up a new enterprise. As no definite figures are available with which to demonstrate that the enterprise is a paying concern, it is almost essential to a successful appeal for capital to quicken the

speculative appetite of the public by lavish advertising and other more subtle methods of arousing interest. All this costly expenditure is paid apparently by the promoters and vendors but actually by the company itself, if and when floated, and consequently all the extra capital with which it therefore had to be loaded, remains a dead weight on its back, adding nothing to its earning power. Hence it is that nearly all these companies are necessarily over capitalized, that is to say, they start with an amount of capital on which they are expected to earn dividends, which is not justified by the actual needs of the enterprise, but is necessitated by the exigencies of this queer system, by which the shareholders of the company finally pay for the wiles by which they were lured into subscribing to it.

In the case of a company formed to take over under the joint stock system a business or industry already established, the preliminary charges are different, but none the less burdensome. In this case, since the business being joint stocked is presumably in a position to show satisfactory figures, giving earnings actually achieved, there is less element of speculation in the matter, and the amount of advertising and preliminary publicity ought to be comparatively moderate. But there is the mysterious entity known as "goodwill" to be paid for. If a well-established business is being

purchased, payment has to be made not only for its actual assets—its land, buildings, plant, machinery, fixtures and stock-in-trade—but over and above for an intangible metaphysical abstraction called its goodwill, which may be said to mean the right to use its name and trade on its reputation. The classical definition of a goodwill was furnished by no other than Dr. Johnson, on the historical occasion when, as executor to his old friend Thrale the brewer, he assisted at the sale of his brewery to two Quaker gentlemen named Barclay and Perkins, who have made it famous throughout the English-speaking world. Boswell relates, on the authority of Lord Lucan, that Johnson, who was bustling about the sale "with an inkhorn and pen in his buttonhole like an exciseman," replied, when asked what he thought to be the real value of the brewery, "We are not here to sell a parcel of boilers and vats, but the potentiality of growing rich beyond the dreams of avarice."

It is a fine mouth-filling definition, but there is a certain vagueness about it, and, as so described, a goodwill is obviously an asset on which a vendor can put any price that he sees a fair chance of getting. Whatever price he does get is an addition to the capital of the purchasing company, which is so much waterlogging dead weight. It is a preliminary expense necessary for the starting of the company, but does not directly help it, when

once started, in its task of earning profits. It gives it a connection to start with, but that connection can only be kept together by the company's own work, and by the maintenance of its product at the old level. If the company is unfortunate and comes to an untimely end, its goodwill, which may be said to be a price put on its earning power, is necessarily worthless, and its presence as an asset in the balance-sheet of the company is to some extent deceptive and misleading.

So far it has appeared from this sketch of the processes which precede the birth of a new joint stock company, that they almost inevitably start on their journey with a burden on their backs. If they are exploiting a new venture, they have to spend a great deal in order to get their capital, and also they very probably pay too much for the patent or concession or whatever it may be that they propose to exploit. If they are acquiring an established business they have to pay something for goodwill, and though in this case they have the great advantage of acquiring realities as well as possibilities, the price of the potentiality remains a charge on their resources until it is written off. If they are of the amphibious kind which acquires a business as a centre round which they propose to build a new and bigger one, they probably have to pay on both accounts—for goodwill and for preliminary arrangement of attractions.

Having grasped this important preliminary fact concerning joint stock companies—that from the necessities of their birth they are more than likely to be weighted at the outset of their careers with a burden of unproductive capital—let us consider what the capital of a company means and how it is subdivided and for what purpose.

The capital of a company is the money that it receives from its original subscribers, to be invested in the acquisition of its business, or the purchase of the plant, land, buildings, machinery, etc., necessary to carry it on. Some of it is usually created as a form of payment to the vendors of the business and assets acquired. As far as this is the case, no money passes between the vendors and the company, but the company issues shares credited as fully paid in whole or part payment of the purchase consideration. For example, we saw that in the case of the Hygienic Toothpowder Company, the vendor of the patent took part of his price for it in cash, and part in cash or shares "at the option of the Directors." This latter phrase meant, that if the public did not subscribe for the shares offered to it, the vendor would have to take shares instead of cash. In the case of shares subscribed by the public, the company takes the subscribers' money, and gives them in return a certificate, stating that they have been registered as holders of the shares or stock

subscribed for. The money thus received by the company from the public, or due from it to the vendors for part of the purchase consideration, thus becomes a liability on its part, against which it sets the assets acquired on the other side of the balance-sheet. Part of its capital is generally kept in hand for the daily purposes of the enterprise, and this amount is commonly called its working capital. It is the sum left over after the company has paid for the assets necessary for the conduct of its business, and we saw in the case of the Hygienic Tooth-powder Company, that after it had paid for its factory, and provided for the necessary alterations and machinery, etc., and given the vendor his price for his patent, it would have £55,000 left in hand as working capital.

A company's capital is said to be watered, or to contain a large proportion of water, when its capital has been largely spent on objects which will not assist its profitable working, or when a large amount of it has been issued to parties who do not furnish it with assets which will assist its profitable working. It does not follow that it has been wasted, for it has been shown that most joint stock companies could not come into existence without a certain amount of expenditure of this kind. In our example the whole amount given ostensibly to the vendor, much of which went through the promoter's hands, for the purchase of

various kinds of "publicity," was water. It is not represented by anything in the assets which could be realized in the event of the company's default, or can give direct assistance in the manufacture of tooth-powder. The amounts paid for the goodwill of a business to be acquired are equally aqueous, and in the case of railway companies or other enterprises, which require Parliamentary powers, the large expenditure necessary on legal and other machinery, in getting anything through Parliament, is inevitably so much water in the capital. In some countries where it is, or used to be, necessary to make use of monetary persuasion in order to open the eyes of the People's representatives, or of the governing authorities, to the merits of the scheme seeking for statutory powers, all these payments were water in the concern's capital. Shares are occasionally given away by very impecunious companies to subscribers to an issue of bonds, and they, again, are mere water in the capital, since dividends have to be paid on them, if they are ever earned, but their issue brings no actual grist into the mill.

The simplest form of capital arrangement is that under which the whole capital is in ordinary stock or shares, all the holders of which share in the distribution of the company's profits in proportion to the amount of capital that they own. But it is more usual in these days to divide the

capital into preference and ordinary shares or stock. Preference shares or stock give the holder the right to a certain dividend before anything has been paid to the holders of the ordinary, and also, usually, in the event of the liquidation of the company—that is the sale of its assets and the return, as far as possible, to shareholders of the amount of their stakes in it—give holders the right to a return of their capital before any payment on this account is made to the ordinary holders. If the preferential rights are cumulative, the preference dividend, if unearned in any year, or for a term of years, must be paid up in full before the ordinary holders share in profits. If not, the preference only extends to each year—or sometimes each half year—of the company's working.

Sometimes, especially in the case of companies working a rather speculative class of enterprise, preference holders, after receiving the full dividend to which they are preferentially entitled, have also the right to a further share in profits after the ordinary holders have received a certain amount of dividend. A cumulative participating preference share is thus very strongly protected. It carries the right to a fixed dividend before the ordinary holders receive anything, so that if the company is only moderately successful its service has to be considered first, and at the same time if the company

earns big profits it gets some share in them, after the ordinary holders have had their slice. This form of preference share, however, is comparatively rare; as a rule, the preference holder takes the first bite out of net profits, and whatever the profits may be, is entitled to no more, though a preference share in a successful company, with a large margin of profit left after its service has been provided, naturally tends to rise in price, owing to its improved security.

The preference share is thus designed to meet the wants of the cautious investor who prefers a comparatively certain yield on his savings to taking the risks involved by ordinary stocks, the income on which necessarily fluctuates with the good and bad fortunes of the enterprise. Nevertheless, it must be remembered that the certainty is only comparative. When misfortune comes upon a company it is a common experience for preference holders to find that their rights receive what they think to be very scant respect. If reconstruction and rearrangement are necessary, the sympathies of the Board are likely to be rather on the side of the ordinary shareholders, since its members are, as a rule, bound to be holders of a certain amount of ordinary securities before they can exercise their function. If the preference holders have a mind to hold out for the strict letter of their preferential rights in the matter of arrears

due, etc., they are apt to be met with a threat of liquidation which is demonstrated to be detrimental to their interests.

Another subdivision of proprietors' capital arises from a system by which, as in the case of many Home Railway companies, the ordinary stock is split or doubled into preferred and deferred, the preferred receiving a fixed noncumulative proportion of the profits and the deferred taking the balance. This rearrangement is often—as in the case of the Caledonian and South Western railways—optional, so that there come into being three classes of ordinary stock, the undivided ordinary, retained by holders who prefer to remain as they are, and the preferred ordinary and deferred ordinary, created under the rearrangement. When a stock is split, the holder of each £100 ordinary receives £50 preferred and £50 deferred. When a stock is doubled, the holder of each £100 ordinary receives £100 preferred and £100 deferred. In either case the profits are divided in such a way that the holders of new stocks created under the rearrangement receive exactly the same dividend as would have been paid on their former holding of ordinary stock. Sometimes the splitting or doubling is not made optional. When the Midland Company doubled its ordinary stock into preferred and deferred, holders were not given any

choice in the matter, and the old ordinary stock ceased to exist, though a dividend is still solemnly declared on it, in deference to Parliamentary injunction.

These splitting and doubling arrangements are justified or excused on the ground that they provide a safer investment in the preferred stock and a livelier gambling counter in the deferred, and so tend to make the joint price of both higher than that of the stock out of which they are created. These ingenious and plausible devices, even if successful, only benefit the shareholders—and the bulls—at the time of the operation. It need not be said that they do not add a penny to the earning power of the company.

Preferred stocks and shares do not usually carry cumulative rights, nor do the preference stocks of English railway companies. There is no essential difference between the words preference and preferred, and as a general rule it may be said that it is most unsafe to draw any inference from the name or label attached to a stock, practice being extremely loose in this respect. The status of every security must be examined separately and without much regard to what it is called. A preference stock may not be cumulative, a preferred one may be. Not long ago holders of a debenture officially described as a First Mortgage were astonished to find that the Board had a

right to create a new security with a charge prior to theirs, and subscriptions were recently invited for a Prior Lien bond, which will be a prior lien some day when a security which ranks ahead of it has been redeemed. "Guaranteed" is another label of very various meaning. The guaranteed stocks of most of the English railway companies rank after their debenture stocks but before their preference stocks, and are cumulative. Owing to the fine security enjoyed by those stocks, the word guaranteed has acquired a connotation which is very misleading when applied—for example—to the guaranteed stock of the Grand Trunk Railway Company of Canada, in which, moreover, many an investor has put money in the belief that it carried the guarantee of the Canadian Government. In fact, the payment of its dividend is only guaranteed by the company, and it only guarantees to do so if it is able to earn it. The stock is simply a preferred stock with no cumulative rights and no special security. One of the first things that the investor has to do is to acquire the habit of looking behind labels for facts.

There is yet another kind of deferred security, which is nearly always expressed in shares. The deferred securities dealt with above came into being by splitting and doubling operations, which made ordinary stocks into preferred and deferred. But these other deferred shares are an ingenious

device for keeping for original promoters or vendors a very substantial share in the profits and at the same time preserving for them an air of great modesty and moderation. For instance, in the prospectus of a dressmaking company launched not long ago, the capital consisted of 197,500 ordinary shares of £1, and 50,000 deferred shares of 1s. All the latter were subscribed for by the vendor, and this absurd little item looked at first sight so insignificant and innocent that one might be inclined to suspect a misprint. Closer examination revealed the fact that after 6 per cent. had been paid on the ordinary shares, the whole of the surplus profits were to be divided equally between the holders of the ordinary shares and the holders of the deferred shares. The prospectus anticipated a net revenue of £24,000, and the 6 per cent. on the ordinary shares, of which only 147,500 were at first issued, would absorb £8850, so that if the promises of the prospectus were fulfilled, the holders of these deferred shares with a face value of £2500, would receive thereby an annual income of no less than £7575, or over 300 per cent. Formerly, deferred shares of this kind used generally to be called founders' shares; sometimes they are labelled management shares and are given to the Managing Director, manager, and chief officials. It is customary for financial purists to denounce them with bell, book and candle,

and to regard their presence on a prospectus as almost sufficient reason in itself for damning it. Nevertheless, there is not anything necessarily vicious about them. It is reasonable enough that the promoters or vendors should keep a substantial interest in a company that they float, and it should be observed that the deferred shares only begin to be a source of income after a good round dividend has been paid on the ordinary shares. Like everything else this question is one of degree. In the case referred to above, the deferred shareholders would receive £7575, but before they received a penny, the ordinary shareholders would pocket £8850, and if the deferred got their £7575, a similar amount would also go to the ordinary.

Deferred shares or founders' shares or whatever they may be called, may be perfectly legitimate and cause no mischief in an honestly conducted and prudently financed company. But they are apt to carry with them a strong temptation to bad finance, the most common and disastrous form of which expresses itself in the payment of too big dividends. Since the deferred shareholders only share in profits after a certain dividend has been paid, it is to their interest that this dividend and something over should be paid as soon as possible, whether it has been well and truly earned or no. As we showed in our imaginary sketch of the inception of a company, the Directors, who are supposed

to be a committee representing the shareholders, are actually in the first place found and appointed by the promoters, and it is, therefore, sometimes possible that the influence of the deferred shareholders may be strong enough in the councils of the Board, to spur it in the direction of too lavish dividends. This is the more easily done since the average member of the average Board probably knows little concerning the profits that the company is really earning, or the proportion of them that ought to be spent on depreciation and maintenance. He only knows that the balance-sheet shows a certain balance in hand, and, as he is apt to judge of the success or prestige of a company by the dividend that it pays, he is naturally prone to be in favour of distributing as much as possible of this balance in dividend. The influence of the deferred shareholder is thus topdressing an already fertile soil, when it urges the Board to bad finance. The company makes a bad start in fact, by making a strikingly good one on paper, by declaring big dividends in its early years—as can generally be done by neglect or ignorance of the obvious fact that the nice new plant will not last for ever—the deferred shareholders receive a return which perhaps enables them to dispose of their holdings on very advantageous terms, and the company is embarked on a career of bad finance which brings its inevitable reward in due course. It is this

indirect influence towards the tempting path of bad finance that makes the existence of this kind of deferred shares objectionable, rather than any essential unfairness in the original arrangement as between them and the ordinary shareholders.

We have not yet exhausted the classes of deferred shares. Besides those that arise from the splitting of ordinary into preferred and deferred, and those given as a special bonus to founders or promoters, with a right to a half or some other large proportion of the profits after the ordinary have received a certain dividend, there is another, comparatively rare class, ranking behind the ordinary for the final profits of the company. The existence of this class of deferred share practically turns the ordinary into a preference share. It was favoured by Mr. Hooley in the curious class of finance that he introduced when engaged in the business of buying up companies, rearranging their capitals and selling them to a new set of shareholders. For example, he bought up the property of Bovril Ltd. for £2,000,000 and sold it again to a new company called Bovril (British, Foreign and Colonial) Limited* for £2,500,000. Since it was to be presumed that the price which he paid for it was at least ample in the eyes of its former owners, who otherwise would hardly have sold it, it was natural that the offer of it to the

* The name was afterwards changed back again to Bovril Ltd.

public at half a million more should be regarded as somewhat audacious. The new company had £500,000 Debenture stock, £500 000 5½ per cent. cumulative preference shares, £750,000 7 per cent. cumulative ordinary shares, and £750,000 deferred shares. The ordinary were entitled to a fixed cumulative dividend of 7 per cent., which has been paid to them regularly, and makes them preference shares in fact if not in name. A similar arrangement was made in the capital of the Dunlop Pneumatic Tyre Company and other ventures that were transformed, by a touch of Mr. Hooley's wand, into concerns with much larger capitals on paper, and no more assets or earning power.

We have thus surveyed the chief forms which are taken by the capitals of joint stock companies — guaranteed securities, preference, preferred, ordinary and deferred. We saw that guaranteed stocks generally rank before the preference, and carry the right to a cumulative dividend, that preferences rank before the ordinary and generally carry a cumulative dividend, that preferred securities generally rank before the deferred and are generally non-cumulative, that ordinary securities take the ultimate profits of the company after the rights of the guaranteed and preference securities have been provided for; that they sometimes share part of the profit with founders' or deferred shareholders, after receiving a certain

proportion themselves; and that they are sometimes split into preferred and deferred, of which the preferred rank before the deferred for a non-cumulative dividend, and the deferred take the balance of the profit. The various classes are thus complicated by many variations, and there are so many exceptions to the general rule that decides their labels that it is impossible to be certain from the mere name of a security concerning its actual position with regard to the rest of the capital.

It is perhaps necessary to add, in the interest of clearness, that all these classes of securities may be indifferently expressed in any of the forms of securities examined in Chapter II. A preference security may take the shape either of registered stock, registered shares, or bearer shares; and so on with all the others. In Chapter II. we dealt with their forms, and we have now endeavoured to throw some light on their relative positions, in the matter of their standing with regard to one another.

Besides their capitals most companies have a debt. Most of them, in fact, have many, and it is usual to see in a balance-sheet a loan from bankers, sundry creditors, bills payable, and other items showing that the company, as is natural, owes considerable amounts in the ordinary course of business. But besides these, there is generally a debt, forming part of the original fund with

which it started, or subsequently raised for the expansion of the business, and against which it has issued stock or bonds to public subscribers. This debt is thus in many respects similar to the company's capital, and is often included with it when the extent of its liabilities on capital account is considered. The stock or bonds issued against it are called debenture stock, debentures, or bonds, and rank, without any exception that I know, before the preference or any other form of capital. It is sometimes assumed that any security with the label debenture or bond attached has a special kind of sanctity, and may be regarded as a sound investment without further inquiry concerning its standing. In fact, this label implies nothing more than the fact that the stock or bond represents a debt owing by a company, which may be under no obligation to pay it, and is sometimes worth no more than an I.O.U. signed by Mr. Richard Swiveller. A debenture stock or bond should be secured by a trust deed giving it a definite mortgage on the real property of the company, which should be valued at at least half as much again as the amount of debt secured on it. Thus, £500,000 of debenture stock secured by a first charge on freehold land and buildings valued at £750,000 may be considered sound if the valuation is fairly recent; though the unfortunate experience of the Law Guarantee and Trust Society, now in

liquidation, shows that a valuation is, by itself, a very weak reed to lean on. The Society guaranteed loans secured on certain properties valued at £4,912,516; the estimated present value of these properties, at the time when liquidation was decided on, was found to be £1,705,153. The debenture stock or bond should also have a floating charge on the other assets of the company, and should carry with it the right of foreclosure, that is to say, it should be within the power of the trustees representing the debenture holders, in the event of the interest not being paid on any due date, immediately to take possession of the property and sell it. Some debentures and debenture stocks are perpetual, and give the holders no right to demand the repayment of their capital, and the company no right to repay it. Most of them are repayable at a certain date, and when this is so, the trust deed should contain provisions for the redemption of the debt at the date named by the setting aside of a certain sum every year to be paid over to the trustees, and used by them either in the purchase of the stock or debentures in the market, or in drawing debentures for redemption by lot, or by the payment of the premium on a redemption policy with an insurance company, or by the purchase of securities to be realized when the debt falls due. Hedged about by these protections, and with a

really adequate margin of assets and earning power behind it, a debenture or debenture stock acquires some of the sanctity which common opinion is too apt to attach to them whether thus protected or not. Without them a debenture is a mere pre-preference charge, on which the company will pay interest as long as it can and regretfully withhold it when it cannot.

CHAPTER IV

PROSPECTUSES

A PROSPECTUS, for the purposes of this inquiry, is a document inviting subscriptions to an issue of any kind of security.

It is clearly inevitable that there should be a considerable difference between prospectuses that invite subscriptions to a loan offered by a government or municipality, and those that invite subscriptions to the securities of a joint stock company, so the two kinds have to be considered separately. Company prospectuses are in some respects the more complicated and interesting variety, and we will take them first.

All prospectuses should be scanned in a spirit of jaundiced criticism, and with the most pessimistic readiness to believe that they are speciously alluring traps laid by some designing financier to relieve the reader of some of his money. No allowances should be made, and the benefit of the doubt should never be given to the prospectus In fact, a large number of them are quite reasonable propositions put forward by quite honest

men, but when they are of this kind they will, or ought to, stand the most sceptical scrutiny, and when they are not, it is a service to the community at large to put them as quickly as possible in the waste paper basket. When they arrive by post or thrust themselves on your attention in the columns of your newspaper, your first instinctive thought should be that here is somebody wanting your money, and that he may be a descendant of Dick Turpin throwing back to his distinguished ancestor, and practising brigandage in a more modern and much less attractive form.

So much had to be said because the kindliness of human nature, strongly reinforced by man's natural greediness, sometimes leads it into mistakes in this connection. I have heard of a case in which a kind old lady sent a cheque for £200 in application for shares in a gold mine because she thought it was so nice of somebody to write to her about it, and because it really looked as if it might be very rich. The gold mine, of course, is still searching for its reef.

In company prospectuses the first item to be looked for is a statement at the top to the effect that a copy of this prospectus has been filed with the Registrar of Joint Stock Companies. If this statement be absent the prospectus is not a prospectus under the Joint Stock Companies Acts, and those responsible for its drafting run less risk of

being made uncomfortable if its statements are shown to have been false. The omission is not enough in itself to damn the prospectus, but it should quicken still further the scepticism with which it is perused.

Immediately below the title of the company should come a line stating that it has been incorporated under the Companies' Consolidation Act, 1908. That means to say that the company itself has been formed according to the provisions of English law, and that holders of its securities are entitled to such protection as the English law affords to them. This protection is sufficiently inadequate, tardy and expensive, but it is at least on the spot and can be more easily set in motion on behalf of English shareholders than if the company be registered in New Jersey or the Transvaal. This matter, again, is not necessarily vital. An American or Canadian company, seeking capital in England, may for quite natural and honest reasons be registered in its home under the laws of its State or Province. But its being so registered is in any case a drawback, for the reason given above, and when the company is English, or semi-English, but prefers to register itself under the laws, for example, of some foreign country where it may carry on part of its business, scepticism is entitled to scent something suspicious.

Next comes the statement of the company's

capital and debenture debt, if any. It is important to observe that the capital is not top heavy. That is, there should not be too big a load of debt and preference ranking in front of the ordinary. The ordinary capital ought to be at least one-third of the total. If this be not so, the margin of income available after the provision of the debenture interest and preference dividend is not likely to be sufficient to give the debenture and preference securities real security, and since a certain risk and liability to fluctuation is essentially connected with ordinary shares and stocks, it is to the debenture and preference issues that the genuine investor has to look. If debentures or debenture stock are offered, there should be here a clause stating the security on which they are based, and it is very important that they should be clearly shown to carry a mortgage on property and assets which appear from the valuation given in the prospectus to promise an ample margin if they should have to be realized by the trustees for the debenture holders, owing to a default in the payment of their interest. An examination of the terms of the trust deed should in all cases be made by subscribers to debenture issues who want to know exactly how and where they stand It is not essential always to insist on a first mortgage. In the case of a large and wealthy concern, good security may sometimes be given by a second or even a third charge, but

mortgage rights, carrying with them the power of foreclosure, are always desirable to complete the security of the debenture holder. Their absence in the case of the English railway companies is condoned by investors, partly because the debenture stocks of most of the Home Railway companies come within the provisions of the Trustees Acts and are thereby accepted as "gilt edged," but chiefly because the great importance of the transport industry makes the I.O.U. of the best of these companies safe enough for practical purposes. Nevertheless, the absence of mortgage rights is a weakness in an otherwise watertight security.

After setting forth the arrangement of the company's capital and debt the prospectus becomes personal and human by proceeding to give the names of the Board of Directors, Trustees for the Debenture holders, if any, Bankers, Solicitors, Auditors and Brokers. Great importance is usually attached to these names, but they probably count for much less than is usually supposed.

Theoretically, the Board is a committee chosen by the shareholders to supervise the conduct of the company in their interests. Actually, as has already been shown, it is in existence before the shareholders are asked to subscribe, and when any of its members retire a new one is chosen by the rest and his appointment is formally confirmed later by

the shareholders. The arrangement by which two or more members retire each year by rotation and offer themselves for re-election is in most cases a mere ceremony, but is very useful as giving an opportunity for mutinous shareholders occasionally to give practical expression to their views. It is not contended for a moment that the Board ought to be really elected by the shareholders, who would probably make an extremely bad choice. I am only endeavouring to show that fact and theory are here at variance. If the Directors were chosen as experts likely to be able to contribute to the successful management of the business, their actual choosers would not be a matter of great moment. As it is, what is chiefly sought for is a list of names likely to strike the public fancy. In old days gentlemen of title were preferred, or retired administrators with a row of letters after their names. Nowadays, it is more fashionable to fill Directorships with people who may be supposed to know something about the purposes of the company. This is a distinct advance, and shows that the education of the investor has made some progress, but the real requirement, that of genuine business capacity, is still to a great extent left out, and probably must be as long as Directors' fees are on their present absurdly small scale. If real experts were wanted to take a genuine part in the management of the business, a bigger inducement

would have to be offered in order to attract them As it is, the actual management is usually left to the manager, who often is also a member of the Board, and is called the managing Director. In exceptional cases, especially when well managed businesses are joint stocked and the Board is made up of the former partners, a really good Directorate is one of the chief points of a prospectus. As a rule, it may be said that as far as the actual conduct of the business is concerned the chief hope for the salvation of an industrial company lies in a good manager and staff, and a Board that will interfere with them as little as possible. But on the very important question of finance,—especially in the matter of the amount distributed in dividends or reserved for depreciation—the Board usually decides, and its decision on this point has a very potent effect on the fortunes of the company.

A point to be noted with regard to trustees for debenture holders is that they should not also be Directors. As trustees they have to uphold the interests of the creditors, as Directors they stand for the proprietors. By joining both offices they attempt the impossible task of representing both creditors and proprietors. As long as the company is prosperous, these interests are unlikely to clash, but they are almost certain to do so if its affairs go awry.

The names of the bankers used to be looked at

carefully at one time, when a theory was current that a good bank would not allow its name to appear on the prospectus of a company of the soundness of which it was not convinced. This theory has been abandoned, since it is hardly possible for a bank to make itself thus responsible. It takes the account of a company just as it takes yours or mine, and does not trouble itself greatly concerning its prospects, as long as it keeps a reasonable balance, or is prepared to pay reasonably, and provide adequate security, for an overdraft or advance.

Auditors are supposed to be elected by the shareholders to check the company's accounts in their interests, and to see that the balance-sheet prepared by the Board is correct. Their functions and the importance of their office will be more fully discussed later when we come to examine into company balance-sheets. At present it need only be said that the employment of a really careful firm which takes an exalted, or even exaggerated, view of its duties, is a strong influence on the side of good finance, and against the tendency to over-distribution of profits, which is one of the greatest dangers to which joint stock enterprise is exposed.

Finally, the brokers, whose names are thought so little important that they are often not printed on the prospectus, are in many respects the surest

guide to an opinion on the issue that it offers. A good firm of brokers will not put their names on a prospectus unless they are satisfied that the securities offered are such that they could recommend to their own clients, not necessarily as an impregnable investment, but at least as representing a proposition that is honestly meant, straightforward and cleanly financed. If the stock purports to be an investment they will have taken pains to satisfy themselves that the security is ample. If it be of a kind—such as a share in a rubber company—which necessarily involves some speculative risk, they will have required evidence that those who embark in it have at least a fair chance and that the company is not hopelessly waterlogged at the outset.

On these points a good firm of brokers is much more easily able to come at a sound opinion than most other people, and their hall mark on a prospectus is thus of the highest importance. Moreover, a good firm of brokers will have a good set of clients, who will follow their lead and subscribe to the issue, and it is of enormous advantage to a security that it should be well held. I am here using the word good in a purely material sense, meaning people with plenty of money and some financial intelligence, who will not clamour for high dividends and be in a hurry to sell their stock at a profit, and who, if anything goes wrong,

will be in a position to weather a storm without throwing their stock away, and give the company further financial support if it be required. Stock that is held in weak hands cannot be a good market, and the success of a company probably depends, after its management and financial policy, as much on the position of its holders as on anything else.

After these personal questions we come to the object for which the company has been formed. For reasons given above, it is almost impossible to regard as genuine investments the securities of any company formed to develop a new industry, to work a new patent or to undertake any new enterprise that has not been actually tested under business conditions. However attractive the estimates and probable the success may seem there must always be an element—or several elements—of uncertainty and a trail of speculation across it. Among innumerable examples of the truth of this truism, let us take the case of a little company called the Cape Glass Company, formed in 1902 under English law to make glass bottles and other articles in Cape Colony. On its Board were two Directors of a brewery company in South Africa which had the highest reputation and credit. An important outlet for the company's product thus appeared to be secured. It was also protected by the high cost of transport in the case of imported bottles. The natural conditions for the

manufacture of glass in Cape Colony were especially favourable, a plentiful supply of sand and other ingredients being at hand on the spot. The company's capital was moderate, and there was every indication that the concern was clean and honestly meant. It never paid shareholders a penny, and a winding up resolution was passed in December 1905. Here there was no question of a new and untried patent, but merely one of planting an industry under apparently favourable conditions, in a new place.

When it is a case of the joint stocking of an established concern it is first of all important to see why the change is being made and whether continuity of management is provided for. It is not necessary always to assume that because a business is being sold to the public its present owners must therefore be convinced that it is high time to be quit of it. If further funds are required for the expansion of the business, or one or several of the partners are retiring and withdrawing their capital, it is reasonable enough to appeal to the public, and this is most easily done by the creation of a joint stock company. But a certain amount of individual interest is thereby generally lost, and if it appears that there is a general exodus of the old organizers, and that no arrangement has been made for the continuance of the management on the former lines, the new company becomes more or less a new

venture and must be branded with the speculative mark. Much will also depend on the nature of the business that is being offered to the public. Some are by their nature and essence much more liable to fluctuation than others, owing to greater variation in the demand for the product. Commodities like clothes and food are always wanted, and though the fortunes of catering and drapery companies have shown very great differences in the results achieved, these differences have arisen chiefly from the special importance of good management in concerns of this kind. Iron and steel companies depend on the vagaries of foreign trade, and there are innumerable examples of enterprises in which excellent management and good finance may be robbed of their well-earned reward by a change in fashion or some prank played by the weather at home or abroad which will upset all calculations. Brewery companies used to be regarded as among those which possessed a commodity for which the demand was practically unlimited, though what economists call the effectiveness of the demand—that is the power of those who wanted beer to pay the price asked for it—varied to some extent with the fluctuations of trade and the spending capacity of the masses. But here a change of fashion has intervened, and the growing sobriety of the community, lately assisted by legislation, has punished an industry,

which had already bared its own back to the birch by its enthusiastic eagerness to buy licensed houses at inflated prices.

Having weighed in a critical balance the prospects, as a whole, of the industry in which he is invited to take an interest, the reader of a prospectus proceeds to the record of the particular business which asks for subscriptions, and should here insist on the most open frankness and candour. This record is contained in the statement of past profits, and the enumeration and valuation of the assets to be acquired. The profit statement should be given year by year, and for six years at least. Sometimes a prospectus will state that for trade reasons it is obviously undesirable to disclose the amount of net profits earned by the business, or words to that effect, but the latter-day investor should be too well educated to be misled by this thinnest of all excuses. For a business that is going to be joint stocked will be obliged to disclose its profits to its shareholders later on, and so this secrecy, alleged to be necessary for the conduct of its business, will have to be given up. An average statement showing that the profits have averaged so much over a term of years, naturally provokes the inference that their volume has been going steadily downwards, for otherwise—if they had been steady or advancing—they would naturally

have been set forth year by year. If they are only shown for two or three years, the spirit of sardonic scepticism in which all prospectuses should be scrutinized, suggests that if the curtain were raised higher, the prospect would be less alluring. It is also important to observe the meaning put on profits by the drafter, and to make sure that their figure is not arrived at without due allowance having been first made for depreciation. Depreciation, as will be shown in a later chapter, is the rock on which bad finance is most frequently wrecked, and in its treatment lies the difference which divides the spendthrift company from the sound. At present, it need only be said, that any individual or company that has earned £1000 and spent £500 in doing so, and therefore, proclaims a profit of £500 before first providing not only for the upkeep of plant and buildings, but for the inevitable day when they will have to be replaced, is afloat on a sea of delusion which will some day swallow him or it. If the profits are, as they should be in a good prospectus, certified by a firm of reputable auditors, this point will be dealt with, as far as auditors can deal with it, another point which has to be for the present postponed. But when the profit statement is given on the authority of the vendors, it is very necessary to look behind the label for the fact, and to make sure that when profits are alluded to it is real genuine

net income, available for distribution, that is meant.

If the profit statement be satisfactory, and earning power be shown to suffice for a good round dividend, it is too often assumed that there is no more to be asked. The judicious inquirer takes a quite different view. He wants to know what real assets the company is receiving in return for the subscriptions that are being asked from him, knowing that the answer to this question will tell him in the first place how much water is being pumped into the capital, and in the second, how the creditors and proprietors are likely to fare, if it should happen that the earning power subsided towards vanishing point. Consequently, he requires a full and definite statement, setting forth in detail the assets acquired, and their values as estimated by, as far as possible, independent experts. Freehold or leasehold land and buildings should always be valued by surveyors, and an independent valuation of the plant and machinery is also desirable In the matter of stock in trade, it may be considered sufficient to insist that it should be taken at cost price, and on this point the testimony of the vendors is generally accepted. The book debts, if any, should be guaranteed by the vendors to realize a certain amount, and it should be stipulated that, if they do not, the purchase price will be reduced by the extent to

which they fail. The amount paid for the good-will must be definitely stated, and though it is dangerous to lay down a hard and fast rule on the point, it may be said, as a general maxim to which exceptions are admissible, that it should not be more than three times the yearly net income, taken from the lowest year's profits shown in the profit statement. It need not be said that if the company takes over any liabilities their nature and extent should be clearly shown.

In a prospectus of the kind that we are now considering it is usual to see in the third page a string of contracts in very small type, which have formed part of the preliminary arrangements of the company's existence. They are generally expressed in a very highly condensed form, and this fact, with their small type, makes them a most unattractive study. Nevertheless, they should always be looked through, and their perusal often repays the effort. If the concern that is being acquired by the new company has passed through the hands of several subvendors, it is here possible to trace the intermediate profits made by them, all of which, be it observed, are ultimately paid by the shareholders of the new company, in meal or in malt, in cash or in securities. If A sells a business to B for £50,000 and B sells it to a company for £100,000, A and B are both made happy at the expense of X, Y and Z, shareholders in the company,

who have either paid the £100,000 in cash, or have added so much to the capital on which their Directors and officials have to try to earn dividends. And it is thus necessary to read these contracts with inquisitive diligence.

Plausible irrelevancies on a prospectus should be taken as strong evidence against it. For example, it is common to see some little gas company, formed to illuminate a sparsely inhabited district, flaunting a list of the prices and dividends of companies serving densely populated towns, as if there were any possibility that the new venture, under entirely different conditions, could achieve similar success. New insurance companies frequently tempt investors by showing how enormously profitable is the business of concerns with centuries of experience and reputation behind them, the mere existence of which is, in fact, a very great difficulty in the way of the establishment of a successful competitor. Because other companies do well, a new company has no right to claim that it will do well, and to charm your money out of your pocket thereby. This kind of appeal is, in fact, highly suspicious.

All these inquiries and investigations into a prospectus, that are essential before any one is justified in investing money on the faith of it, are evidently beyond the capacity of the average investor. Most of them, perhaps, have sufficient

understanding of figures to enable them to read a statement of profits, and to scan the valuation of the assets. And if they can do this with a sufficiently sceptical intelligence, they will in most cases have got a certain amount of basis for a reasoned judgment on the company's possibilities. But in investing money it is not enough to aim at a certain amount of judgment in most cases. There are so many chances against which it is impossible to guard, that it is criminally foolish to omit any precaution that is possible. And even in the comparatively clear and simple parts of the prospectus, namely the profit statement and valuation—if they are not clear and simple the prospectus should be thrown away at once—there may be always some lurking technicality which will escape an untrained eye, but may at once be marked as a danger signal by an expert.

With regard to the even more important side of the prospectus which shows, or rather hides, the human element of the matter, the average investor can hardly have a glimmering of light to help him. The more light he has, the less help he will probably get. If the names on the prospectus are known to him it is fairly safe to infer that they are not the right kind of names. In old days, when the public used to subscribe to new issues because it saw some distinguished Peer or retired administrator or

battle-scarred veteran on the Board, it did not make the mistake, with which cynical observers often credited it, of thinking that these illustrious gentlemen were capable men of business, able to conduct the operations of the company. What it thought was that here were big men with big names to lose, who would not wittingly have put their names on anything unsound. So far the instinct of the public was right, but it forgot to consider that the capacity of these ornamental folk for judging of the soundness of the business was extremely limited, and that sometimes the modern standard of ostentation and extravagance made big men with big names rather too eager to earn a few hundreds by sitting on Boards and signing their names periodically, without sufficiently reflecting that by so doing they were helping to dazzle the judgment of investors at a moment when it ought to be most severely critical.

A real business man who will be a good and efficient Director of a company, is most unlikely to have any sort of handle to his name, or to be in any way known or notorious to the public at large, and hence it follows, that the more the average investor thinks he knows about the names on a prospectus the more probable it is that he will be misled. The ornamental director with a name to lose is somewhat out of fashion, though not altogether extinct, but the alleged "practical man"

who has succeeded him is no easier for an outsider to weigh in the balance. If he be merely a member of a firm whose business brings it into practical acquaintance with the enterprise intended—and this is the best kind of Director—the investor will never have heard either of him or of his firm. If he be on the Board of many other companies which are at work on similar enterprises, this may be said to be more or less evidence in favour of his knowing something about the matter in hand. But it is not at all conclusive, for he may be a mere dead-head or cipher in them all, and just an accumulation of well-distributed ignorance.

With all these difficulties in his way in assessing the value of the Board, the average investor may be assumed to be quite as unable to draw any valid inference from the names of the solicitors, auditors, and brokers. He may happen to know that the brokers are a really good firm, but it is much more probable that he has never heard of them.

Moreover, it very often happens that the name of the parties really responsible for the issue and for the management of the company, and for watching over its financial arrangements, do not appear at all on the prospectus, and are only known to those who are behind the scenes. From all these considerations we arrive inevitably at the conclusion that any investor who has no special knowledge to work on commits a very serious

indiscretion by subscribing for any new issue on his own judgment, based on a perusal of the prospectus, and without the counsel and advice of his stockbroker. It cannot too early be grasped by any one who is in a position to invest money, that the judicious investor is the investor who rejoices in a good broker, trusts him and takes his advice.

It may be objected that if investors always waited for their brokers' advice before applying for new securities, they would often miss a chance by being too late in sending in their subscriptions. Perhaps they would, but they would still oftener be saved from exchanging their money for quite worthless certificates. I have even heard it contended by a veteran student of these matters, rather from the point of view of the seamy side, that no one should ever, under any circumstances, apply for a new issue, because if it be good he will be shut out and receive a letter of regret, and if it be bad, he will find himself possessed of the whole amount that he subscribes. In its naked completeness this theory will not hold water. It assumes, in the first place, that when an issue is sought after the outside applicant has no chance, because the whole is allotted to favoured subscribers. And though allotment does sometimes, and to some extent, go by favour, and the practice of giving marked application forms, which receive

special treatment, to friends of the issuing firms, has lately been too general, the assumption that the outsider is altogether ruled out is a most slanderous exaggeration. In the second place, this theory assumes that an issue which is good is necessarily an issue which is eagerly subscribed for, and this is by no means always so.

Nevertheless, though the sweet simplicity of the statement that all prospectuses should be put straight into the waste-paper basket, is too sweeping for endorsement, it is only an exaggeration. No outsider should ever apply on his own responsibility, and at least in the case of industrial ventures there is much to be said for the view that he can always do at least as well by investing in some security that has stood the test of time, and has a history and a market, and something better than the clearest and cleanest prospectus figures, on which to form a judgment on its merits. Subscriptions to prospectuses are attractive to the thrifty-minded investor, because he pays no commissions and stamps, and has not the "turn of the market," —a phrase which will be made clearer later on— always against him. He can also flatter himself that as a considerable block of stock or shares is being offered, the price must be made cheap and alluring, and that he thus gets his holding on comfortable terms. But when all has been said in favour of this mode of investing, its drawbacks

may still be said to outweigh them. The investor fancies that he is getting stock cheap and paying no commission, but we have seen that there are very heavy expenses connected with the launching of a company, and that these are, in the end, paid by the shareholders. New issues of stock or shares by existing companies are in a different category. Here there is all the advantage of a cheap and attractive price, no commission, no turn, and no stamp and transfer fee, combined with the past record of the company's achievements and of the behaviour of its securities in the market But then, issues of this kind, if they are good, are commonly offered only to the shareholders of the company, and give the outsider no chance

Prospectuses which offer Government or municipal loans stand apart from the ordinary industrial variety. In their case it is unusual to find much information that can give a definite indication concerning the real solvency of the borrower. The Governments of the great nations do not, as a rule, condescend to say anything. They invite subscriptions, pledge their citizens, and their posterity, to meet the service of the loan, and there's an end on't. Subscribers compare the price of the stock with that of the existing obligations of the Government in question, make up their minds, in some haphazard method, that the nation behind it is rich enough to meet its liabilities and honest

enough to want to do so, and subscribe on the faith of the market price and a hasty generalization, half economic, half psychological, and all guess-work. As an example, let us consider the last big public issue of British Government stock, made in July, 1910, under the Irish Land Acts. The prospectus merely states that H.M. Treasury has fixed the price at 92½, that the Bank of England will receive applications, that the stock consists of perpetual annuities, yielding dividends at the rate of 3 per cent. per annum, and is not redeemable until the 3rd December, 1939, after which it may be redeemed at par, on three months' notice; and that the dividends will be paid out of the income of the Irish Land Purchase Fund, and "if that income is insufficient, will be charged on and paid out of the Consolidated Fund of the United Kingdom or of the growing produce thereof." It will be observed that nothing is said about the establishment of any definite arrangement for the redemption of the stock, and that the subscriber has no right to repayment. The Government can redeem if it pleases, but if not, can go on owing the money till the crack of doom. This option in its favour leaves the lender at the mercy of the vagaries of the money market. If money is cheap, and so difficult to invest, in or after 1939, he will have his money repaid. If not, he has no right to any return of his capital from the borrower, and if

he wants it, must sell his stock as best he can. It may also be observed that even more remarkable than the omissions are the actual statements of this prospectus. If it had been issued by any less august borrower its phraseology would have been criticized as absurd. It describes the stock as consisting of perpetual annuities, which implies, if language means anything, that it is a promise to pay a certain income for all time, and that there can be no possibility of any payment or return of capital. And then the next clause says that the stock is not redeemable till after December, 1939, after which it may be redeemed at three months' notice.

Most other Governments couch their offers of bonds or stock in terms less contradictory perhaps, but not much more informing. In May, 1910, the Chilian Government offered an issue of £2,600,000 five per cent. bonds. The prospectus said that the loan was issued in accordance with laws of certain dates, that £1,500,000 was for a certain railway, and £1,000,000 for improvements of the city of Valparaiso; that Messrs. Rothschild would receive subscriptions at 99, and that the loan would be redeemed by an accumulative Sinking Fund. Concerning Chili's debt, resources, expenditure, income, etc., not a word was vouchsafed. This being the style of Government prospectuses, it is obvious that their readers have no opportunity of applying any

intelligence to their perusal, but must needs be content with the happy-go-lucky guess-work method, reliance on the standing of the issuing firm, and a comparison of the price of the new stock with that of the existing obligations, if any, of the borrower. But in view of the pace at which most of the Governments of the world are pledging their credit and the willingness of their posterities to meet the bills drawn on them, it may be that some improvement may be necessary in this respect. Already the appearance, in February, 1909, of an Argentine Government prospectus, showing from 1890 onwards the proportion of total debt charge to total revenue, produced pleasant surprise among critics of prospectuses; and in February, 1910, a Bulgarian loan was announced in a document which gave statements of the Government's total debt, and property, and revenue and expenditure for three previous years. Perhaps the day may come when every prospectus issued by a Government that is borrowing in any country but its own, will show a comparative statement of population, revenue and expenditure, annual debt charge, total indebtedness, reproductive assets if any, and imports and exports; and will contain some definite provision for the redemption of the loan. When this much has been accomplished the financial critics of that happy and far-off future will

doubtless urge the desirability of further information.

Municipal prospectuses, offering issues of stock or bonds on behalf of corporations, have already made some progress along these lines. They generally show figures of the rateable value, the revenue and expenditure, the total debt and reproductive assets such as waterworks, tramways, etc.; and they usually announce provision for the extinction of the debt, offered for subscription, on maturity. As a rule, they think it sufficient to give the figures of the latest completed year, and in this respect they are capable of improvement, for a set of figures standing by themselves, though much better than none, is not nearly as informing as a comparative table, in which growth or decline can be traced.

It may appear to be an audacious impertinence to ask for information from borrowing Governments and municipalities which shall throw some light on the question of their soundness and solvency, and bureaucratic gentlemen who rightly regard the bodies for which they work as in quite a different class from any other borrower, may feel as deeply injured by such a suggestion as was Falstaff when Master Dumbleton "liked not the security" on which he proposed to buy satin for a "short cloak and slops." But a prospectus is a request for a loan of money, or a subscription to

capital, and it is not really very unreasonable to contend that it should give the possible lender a little information on which he, or his expert adviser, may base an opinion concerning the financial strength of the borrower.

CHAPTER V

COMPANY BALANCE-SHEETS

So far, we have dealt with the causes which bring securities into being, their forms and classes, the ceremonies that attend the birth of a new company, and the document that invites subscriptions to its capital. Now we have to consider the statements that it periodically publishes in order to put its position and progress before its shareholders. To most of the shareholders these statements are about as comprehensible as a passage from Browning, translated into an unknown language. It has been said that speech was invented to enable man to conceal his thoughts, and the first sight of a balance-sheet and revenue account generally leaves the uninstructed reader more ignorant than before of the position that they purport to explain to him. Nevertheless, a balance-sheet is really an extremely interesting document to those who will take a little trouble to find out what it all means, and much of its interest arises from the mere fact of its obscurity, and from the very shadowy and elusive nature of

any meaning that can in many cases be got out of it.

As an example of a clear and good balance-sheet of an industrial company, I append on the following page that of Babcock and Wilcox, Ltd., the well-known engineering company.

At first sight the whole statement seems to be mere midsummer madness. It shows two divisions with a line between them, and with totals balancing. The most inexperienced inquirer probably has a dim and hazy notion, that on the left side of this line are the liabilities, and on the right, the assets. But a liability, if it means anything, must mean something that the company owes, and yet the greater part of these alleged liabilities consist of the company's capital, reserve funds of various kinds, and its profit and loss balance. The only items among the liabilities that really look like a liability are the dividends unclaimed, and "sundry creditors," and these two only come to about £150,000 out a total of over two millions. Faced by problems such as these the shareholder, who is not versed in the mysteries of balance-sheets, is apt to dismiss them as impossible cryptograms, with an esoteric meaning that is only revealed to an initiated caste, after much fasting and mortification.

These difficulties are merely superficial, and a little explanation makes the liabilities side of

BABCOCK & WILCOX LIMITED

Balance Sheet, 31st December, 1909.

Dr.

To CREDITORS :—				
Sundry Creditors		£148,763 6 1		
Dividends unclaimed ...		1,142 0 0		
Reserve for estimated further Expenditure on orders invoiced, fall in value of Investments, &c.		139,847 3 1		
			289,752 9 2	
To CAPITAL :—				
Authorized and Issued.				
100,000—6 per cent. Cumulative Preference Shares of £1 each, fully paid		£100,000 0 0		
830,000—Ordinary Shares of £1 each, fully paid ...		830,000 0 0		
930,000 Shares			930,000 0 0	
To RESERVE FUND			500,000 0 0	
To DIVIDEND EQUALIZATION FUND			195,000 0 0	
To PROFIT AND LOSS ACCOUNT :—				
Balance brought forward ...		£43,278 19 9		
Profit for the year ending 31st December, 1909 ...		360,003 15 0		
		£403,282 14 9		
Deduct— Interim Dividends paid 11th October, 1909				
On Preference Shares ...	£3,000 0 0			
On Ordinary Shares ...	66,400 0 0			
		69,400 0 0		
			333,882 14 9	
			£2,248,635 3 11	

Cr.

By CASH AT BANKERS on Deposit, and Current Accounts, and in Hand London, Glasgow, and Branches	£325,669 0 1
By INVESTMENTS AT COST	552,303 0 3
By BILLS RECEIVABLE	20,306 6 9
By DEBTORS	558,266 0 0
By EXPENDITURE ON ORDERS NOT INVOICED ...	61,020 0 1
By STOCK OF MERCHANDISE, AND WORK IN PROGRESS	288,312 14 6
By FREEHOLD LAND and LEASEHOLD PROPERTY, PLANT, BUILDINGS, PATENTS, and SHARES IN ASSOCIATED COMPANIES, including additions for the year ending 31st December, 1909	442,758 2 3
	£2,248,635 3 11

Profit and Loss Account for the Year ending 31st December, 1909.

Dr.	£ s. d.	Cr.	£ s. d.
To Rents, Rates, Taxes, Insurance, and Repairs and Alterations to Offices ...	£6,881 6 6	By Manufacturing Profit, less amount written off—for Depreciation, Managing Director's Remuneration, Secretary and Chief Accountant's Salary and Office Salaries, Bad and Doubtful Debts, Travelling, and General Expenses at home and abroad, but including income from Associated Companies	£365,731 13 9
To Patents Expenses and Fees	2,128 0 4	By Interest on Investments, Deposits, and Dividends on Shares	21,599 11 11
To Directors' and Auditors' Remuneration	5,007 5 0	By Discount and Interest	5,119 15 11
To Income Tax...	18,616 15 9	By Transfer Fees	186 1 0
To Balance Profit for the Year ending 31st December, 1909, carried to Balance Sheet ...	360,003 15 0		
	£392,637 2 7		£392,637 2 7

JOHN DEWRANCE, *Director.*
JAMES H. ROSENTHAL, *Director.*
WALTER COLLS, *Secretary.*

REPORT OF THE AUDITORS TO THE SHAREHOLDERS.

We have audited the above Balance Sheet with the Accounts relating thereto in London, and with the Accounts from the Works. The stock of merchandise and work in progress has been certified by the Works' Manager and Accountant. We have obtained all the information and explanations we have required. In our opinion such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the Company's affairs, according to the best of our information and the explanations given to us, and as shown by the books of the Company.

LONDON. 12*th April*, 1910.

COOPER BROTHERS & CO.,
Chartered Accountants, } *Auditors.*

a balance-sheet quite a simple matter. All that is needed is to look at it from the point of view of the company, and not of the shareholders. Then we see at once that since the company received its capital from the shareholders, it in a sense owes it to them, and has to account for it to them as long as it is a going concern (which it does by setting forth on the other side the assets in which it has invested it), and has to pay it back to them, if it can, if and when it goes into liquidation, that is to say, sells off its assets, pays its creditors, and hands over the balance to its shareholders. Likewise the reserve fund, the dividend equalization fund and the reserve for estimated expenditure and fall in value of investments; these sums have not * been, like the capital, paid over to the company by the shareholders (or the original shareholders, from whom the present ones have bought or inherited their shares), but have been reserved out of the profits of past years, and so must also be accounted for by the company to the shareholders; and the profit and loss balance represents the amount now available (less the dividends already paid out of it) for distribution, addition to reserve fund, and other purposes, with a balance always left over to be carried forward for the financing of the company's future operations.

* In some cases reserves are created or increased out of premiums paid on new issues. See Glossary under "Premium."

It will be noted that the total of the various reserve funds comes to £835,000, and the profit and loss balance to £334,000 (in round figures), so that the company has got, out of previous profits or premiums received, or in hand from the earnings of the year covered by the report, a total of £1,170,000—considerably more than the whole amount of its preference and ordinary capital, which comes to £930,000. The result of the austere prudence of its financial policy is shown in the remarkable strength of its balance-sheet, exemplified by the fact that a very large proportion of its liabilities on paper, are only liabilities in the sense that they have to be accounted for to the shareholders, and paid to them if the company were wound up. In other words, if the business were suddenly stopped and liquidated, the only outside claims on it, at the date of this balance-sheet, are from sundry creditors for the comparatively trifling amount of £149,000, and from individual shareholders who have not claimed dividends to the extent of just over £1000; while, on the other hand, if the assets on the other side were to fetch the figures at which they are entered, the company would have nearly two millions and a quarter wherewith to meet these trifling claims, leaving the whole of the big balance for its shareholders as a whole.

When we look into the figures on the liabilities

side of a balance-sheet, this is the point to which attention should first be given, namely the extent to which the company is indebted to outside creditors as compared with its liabilities to its proprietors. In this case the proportion is trifling, and hence the balance sheet is so far strong. But in the balance-sheet of most industrial companies the sundry creditors' item is likely to be relatively bigger, and there are usually other evidences of indebtedness, such as debentures and debenture stocks (for we know that debenture holders are creditors of the company), bills payable and very probably a loan from bankers; and in the event of the company's being wound up, all these claims would have to be satisfied in full before the shareholders received a penny on account of capital originally subscribed, or reserves built up out of past profits. If, as might easily happen, the assets did not by any means fetch as much as the figures at which they stood, there might very possibly be nothing at all finally left for shareholders.

It is when we come to the assets side of the balance-sheet that its difficulty really begins. On the liabilities side we have been faced with sums about which there is no doubt. Every penny that the company has to account for to its shareholders or pay to its creditors is a definite penny, no more and no less. But when we look

into the assets that it holds against these liabilities there is room for infinite variety in the meaning of the figures attached to them. According to one view of the case, if a company has taken £100,000 of capital from its shareholders and invested it in—for example—merry-go-rounds, it is able to put down, among its list of assets, the item, "By purchase of merry-go-rounds £100,000," apart from any consideration as to whether the merry-go-rounds could realize £100,000, or any sum near it, if it were necessary to get rid of them. On this theory, which is perfectly logical, the assets side of the balance-sheet shows simply the sums spent upon the assets by the company, and has no necessary relation with the question of what the assets might be supposed to fetch. This view makes the assets side of the balance-sheet quite simple and informing as a record of the manner in which the company's capital has been invested, and quite useless as a guide to its actual position at the moment. An instructive example of its uselessness was furnished a few years ago by the company which owned the Gigantic Wheel at Earl's Court. The company invested nearly £30,000 in the construction and erection of the Wheel, and so year by year the Wheel figured in the assets at £29,263. When it became necessary to dispose of the Wheel it fetched £300.

Although from this point of view the figures on the assets side may mean little or nothing to those who are trying to gauge the position of a company, they are comfortably definite, and have a pleasant flavour of book-keeping accuracy. It may not be of great use to know that certain sums have been spent on certain objects, but if this information is all that is required, it is easily provided from a careful collation of the books of the company by those appointed to examine them. Consequently, we find that professional auditors are rather inclined to maintain in theory that this is all that a balance-sheet need tell us—how much on the left side the company has received or owes, and on the right how the company has spent it, and on what. On this point, however, their practice differs widely from their preaching, and if an asset is put in at a price which is easily ascertained to be unwarranted, most auditors would certainly call attention to it in the report or certificate which they append to the balance-sheet.

Before we embark on the very complicated and interesting question of the duty of auditors, it is perhaps better, by a closer examination of the Babcock & Wilcox balance-sheet—which I have selected on account of its comparative strength and simplicity—to make some acquaintance with the superficial aspect of the matter, and see from the

merits and defects of this one, what we ought to expect to find in an ideal example.

Concerning the liabilities side, there is little more to be said. The arrangement is somewhat unusual, since most companies put their capital first, but that is a matter of mere detail. It has already been observed that the sundry creditors' item is small compared with the company's capital and reserves, and if we look at the other side we see that it is also small when compared with the debtors and bills receivable which together amount to nearly £580,000. This is another feature of strength. Most companies and firms take and give credit in the course of their business, but it is more comfortable to be owed than to owe, and the debtors usually exceed the trade creditors in a strong balance-sheet.

The next item is unusual and obscure, and open to criticism in that it mixes together several matters which clearness requires to be stated separately. "Reserve for further estimated expenditure on orders invoiced" may be supposed to mean that goods taken credit for will, or may, cost the company more than has been allowed for against them, and that consequently a special reserve fund has been kept in hand. Reserve against fall in value of investments is clear enough when we note on the other side that "investments at cost" stand at £550,000 odd. Evidently these investments have

fallen below the price at which the company bought them, and a fund has consequently been retained to make good the difference. Perhaps it would have been simpler if the company had written the investments down instead of leaving them at the original price and keeping a reserve against them, and in any case we should like to know how much of this reserve is against fall in investments and how much against estimated further expenditure on orders invoiced, and we very much want to know what is the meaning of the "etc." which concludes the item.

Capital speaks for itself. This is the amount subscribed by the shareholders or taken in shares in whole or part payment for the business by its vendors. It is divided into 100,000 6 per cent. cumulative preference and 830,000 ordinary shares, all of £1 each, and all issued and fully paid. It will be noted that the amount of preference shares is small compared with that of the ordinary, giving them a big margin of income and security.

Then come the handsome reserve fund of £500,000 accumulated out of profits earned in the past, or premiums on issues of new capital, and another reserve fund, labelled for the equalization of dividends—that is, to make good fluctuations in the profits of any year in which adverse trade conditions may affect the company's earnings.

Next appears the item of profit and loss account,

which means the net income earned by the company in the course of its business. The amount of it, which is in this case roughly £334,000, is the sum by which the assets of the company as stated on the opposite side exceed that of the liabilities on capital reserves and creditors, and its inclusion among the liabilities, as an item to be accounted for to shareholders, makes the two sides of the balance-sheet equal one another. We see that it is composed of £43,279 brought forward from the previous year, and of £360,004, the net profit for the last twelve months, less interim dividends already paid; making a net total of £333,883 now available for final dividends on the preference and ordinary shares, and for other purposes. In the report to which this balance-sheet was appended, the directors recommended that dividends should be paid for the second half of the year of 3 per cent. on the preference shares (making their 6 per cent. for the year) and of 8 per cent. on the ordinary, with a bonus or extra dividend of 8 per cent.; they also place another £100,000 to ordinary reserve fund and £25,000 to dividend equalization fund, continuing the policy of strengthening the company's position by keeping in hand a large proportion of the profits earned, and make provisions for their workers by placing £10,000 to a Staff Pension Fund.

On the assets side this company is again

eccentric in arrangement, roughly reversing the order usually observed in balance-sheets. But perhaps other companies also would begin with their cash and investments, if they had so fine a holding of them to show.

The cash item needs no explanation. "Investments at cost" are securities purchased by the company and valued at the price that it paid for them, subject to a reserve fund, the exact amount of which is not shown, held on the other side of the balance-sheet to make good a fall in their value. Bills receivable are bills of exchange that it has drawn on folk to whom it has sold goods, and who, not finding it convenient to pay at once, have accepted (or promised to pay) bills drawn on them due at a later date. Debtors are others who owe the company money in the course of trade, and have merely acknowledged indebtedness on the receipt of goods delivered, without accepting a bill.

All the items so far enumerated may be considered more or less liquid, that is to say, readily convertible into cash. The cash item is absolutely liquid, the investments ought to be fairly liquid, the bills receivable would presumably be met at the due dates, and the debtors would pay what they owe with more or less completeness and readiness, if pressure were applied. Moreover, in the case of all these items, except the investments, a definite sum is owing

or due, and ought to be realized in the event of the company's being wound up. We have seen that against the investments a reserve is held against depreciation, and doubts about the ability of the debtors to meet claims on them in full are met by the line in the profit and loss account which shows that something is written off every year, before arriving at the manufacturing profit, to provide for bad and doubtful debts. Moreover, all these items ought to be good, quite apart from the continuation of the business. Liquidation would not imply that they would have to be realized at a sacrifice, as might easily happen in the case of stock-in-trade, buildings, plant, etc. And another feature of strength in the Babcock & Wilcox balance-sheet is the high proportion that these liquid and relatively liquid assets, which might reasonably be expected to fetch the sums at which they stand, bear to the total.

These more or less liquid assets also possess the advantage of being to some extent amenable to examination by the auditors of the company, who can tell, though in a varying degree, what they would be likely to fetch if sold or realized. In the case of the investments the check of the auditors ought to be ample, since they can examine the securities, and compare the price at which they stand in the balance-sheet with current market quotations, if the securities are, as they ought to

be, such as are publicly quoted. The bills receivable and the debtors are matters of more problematical value, and here the opinion of the Board concerning the solvency of those to whom they have given credit has to be chiefly relied on. The auditors, however, can exercise more supervision over these items than over stock-in-trade, buildings, and plant, concerning which they cannot be expected to produce an expert opinion.

Proceeding to the remaining entries in the balance-sheet we find a somewhat obscure item "Expenditure on orders not invoiced," which presumably means money spent on partially completed orders and seems to differ very little from the next entry, "Stock of merchandise and work in progress," an article in a balance-sheet which is always most difficult to test and verify. The auditors' note shows that in this case, as usual, its value is certified by the Works' manager and accountant, and accepted by them as correct. Clearly this is a matter on which the auditors cannot be expected to give an expert opinion, and the valuation set on this item of "stock-in-trade," or whatever similar label may be given to it, is a pitfall that always lurks in industrial and commercial balance-sheets. In this case the small amount of it, when compared to that of the liquid assets already examined, and the soundness of the balance-sheet in other respects, go far to rob it of

its dangers. But it must always be remembered that this stock-in-trade entry, which has to be left to companies' officials, opens a door to mistakes and worse. A little optimism in the valuation may make a great difference to the profit achieved on paper, as will be seen more clearly when we examine the question of profits in the next chapter, and in the few cases in which fraud in company accounts is attempted, it is generally in the stock-in-trade item that misrepresentation is most easily carried out. Shareholders should always watch it carefully and see that it is not allowed to grow more quickly than the other assets of the company. In comparing each balance-sheet with its predecessor—by which means alone can a really satisfactory examination be obtained—special attention should always be given to this point.

The last item is open to criticism, as including under one heading several things which are diverse in character, and should in an ideal balance-sheet be set out separately. Freehold and leasehold property may perhaps go together, but a separate statement is better even in the case of these two, since one is a wasting asset and the other is permanent, though not necessarily permanent in value. Plant and buildings again are in different categories. Buildings might perhaps be realized as they stood; plant would probably have to be sold for old iron value; patents in the case of

the company's winding up would perhaps have no more value than its goodwill, the absence of which among the assets of this balance-sheet is another evidence of its strength. And finally, shares in associated companies evidently stand in a class by themselves and ought to have been stated apart, instead of being mixed up in the curious medley of which this last item consists. The strength of the balance-sheet in other respects easily outweighs the blot on it made by this mixture, but it would evidently be much more informing if it told shareholders at what price each of the items stood, which are put together in the last entry.

Evidently, if a large number of assets quite different in essence are put together, it is all the more difficult to guess how much of the total at which they stand is their true realizable value. I venture to think that the price placed on the assets of a balance-sheet ought to bear some relation to the price that they might be expected to fetch. If they do not, a balance-sheet is not only useless but misleading, and it is because they often do not, and those responsible for the production of company balance-sheets sometimes see no reason why they should, that company finance is so often unsound. This contention is heretical, but heretical only in theory. In fact, it is in accordance with the practice of the best auditors, up to a certain point.

The whole question of the meaning of a balance-sheet and of the duty of auditors in examining it, is one of very great importance, and would require voluminous treatment for its proper explication. Fortunately it has been treated, with due fullness and in the light of real knowledge and experience, by an acknowledged authority on the subject, in a work entitled "Auditors: their Duties and Responsibilities," by Francis W. Pixley, Barrister-at-Law, Fellow and Member of the Council of the Institute of Chartered Accountants in England and Wales. By this unquestioned authority, the contention that an asset in a balance-sheet ought, if possible, to be valued at a price that it may reasonably be expected to fetch is, as I hope to demonstrate, first damned as heretical, and finally to a great extent endorsed.

In Chapter X.* of his great work, Mr. Pixley begins his exposition of the duty of an auditor to a balance-sheet by the following sentences. "The Balance Sheet is the most important Statement which can be laid either before the Shareholders of a Company or before those interested in any commercial or financial venture, whether speculative or non-speculative, as it shows the financial position of the Company partners, or individuals, as the case may be, according to the Books of Account. A Balance Sheet is not necessarily, or,

* Tenth Edition, 1910, p. 448.

in fact, usually, what so many believe,—or to suit their purposes pretend to believe—a Statement of Liabilities and Assets, using the latter word in the sense of its representing the saleable or market value of each heading or item which appears thereon. A Balance Sheet is simply what its name implies, a sheet or collection of balances, and is really a Statement in an abstract form of the debtor balances and the creditor balances of the Ledger or Ledgers, after the elimination of such balances as have been transferred to the Revenue or Profit and Loss Account."

Here we have the pure milk of the strict book-keeping theory. The saleable or market value of each item is not relevant, and a balance-sheet is simply an abstract of the records of the company's books. Mr. Pixley proceeds to observe that "the fallacy of the popular title is of course seen when attention is called to the fact that the credit side of the Balance Sheet must . . . include all expenditure unrepresented by an asset or any property of value, also all special losses, or the general loss or deficiency to date brought forward from Profit and Loss Account; while, on the other hand, the debit side necessarily includes the Capital of the Company or partners, also any reserve, and any surplus brought from Profit and Loss Account."

As for capital, reserve, and profit and loss surplus, it has already been shown that they are,

in a sense, liabilities on the part of the company to its shareholders, or from the partnership to its partners, since they have to be accounted for by the company or partnership as long as it is a going concern, or paid up if it goes into liquidation. And to Mr. Pixley's demonstration that the credit side of a balance-sheet cannot be a statement of assets, because it must include expenditure unrepresented by an asset of any property of value, special losses, or general loss on profit and loss account, the practical answer is that no balance-sheet of a prosperous or well-established company shows these items on the credit side. Experimental expenditure may be taken credit for by a new venture that has yet to find its financial sea-legs; but any well financed company that has expended its shareholders' money on property of no value ought to write this expenditure off as rapidly as possible, that is to say, set apart part of its profits in order to replace this unrealizable asset by a real one. For example, if Babcock & Wilcox found that machinery standing in their books at £100,000 had suddenly become worthless owing to some new invention, they would write down their machinery by that amount, and would pay away so much less in dividends, with the result that the place of the worthless machinery would be taken in the balance-sheet by the cash retained. Or, since they are so well provided with reserve funds, they would be

justified in writing off this loss out of reserve, and the balance-sheet would be amended by the reduction of the machinery on one side, and the reserve on the other, by £100,000. If a company has incurred a special loss, it would be most unsound finance to include it on the credit side of the balance-sheet. It also ought at once to be written off out of profits. If there are no profits and no reserve fund and nothing out of which the loss can be made good, there is nothing for it but to include it on the credit side of the balance-sheet; and likewise a deficiency on profit and loss account must also be so included, unless there is a reserve fund to write down against it. But then a loss or deficiency on profit and loss account, definitely stated as such, cannot pretend to be an asset. It simply fills the gap, which only occurs in the case of unprosperous companies, between the value of its real assets and the amount of its liabilities on the other side. The existence of this gap, filled only by a loss or deficiency, may in most cases be taken as evidence that the company is in Queer Street. If there is only enough of this kind of asset, insolvency begins to threaten.

There is little need to look for arguments and examples showing that the strict book-keeping theory of a balance-sheet produces a document which is not only worthless but misleading. Mr. Pixley himself, having stated the theory, and

told us that a balance-sheet is really a statement in an abstract form of the ledger balances, gives his own high authority for auditing practice which ignores the theory altogether. "It must not," he writes, "be understood that the Auditor's duty is confined to ascertaining that the items on both sides of a balance-sheet simply agree with the Ledger Accounts, as in those cases where the balances on the credit side of the balance-sheet represent what are known as assets, or property, it is now generally admitted to be his duty to inquire into what may be inserted in this Statement as representing the value of such assets or property."

Here he concedes the whole case of those who contend that the figures inserted against the assets in a balance-sheet ought not to be a mere record of what the company has expended, but should be brought into some relation with the facts of the present moment by due regard for their real value. If it be granted that an auditor ought to "inquire into" the figure set against balances which represent assets or property, it is surely still more obviously his duty to inquire into the figures set against those which represent nothing, and in both cases to use his influence on the side of the policy which adjusts the valuation of realizable assets to their realizable value, and eliminates, by writing off altogether, those of which the realizable

value is *nil*. This policy is exactly what is advocated by this distinguished auditor, though tentatively, and with emphasis that varies with the different items among the assets.

On the subject of the office furniture he is definite and positive. "The Auditor," he tells us, "should be satisfied that the amount taken credit for office furniture does not unduly exceed its value. A percentage should be written off periodically, and charged against the Revenue Account for depreciation, until the balance of the Ledger Account has been reduced to the amount representing its value."

The case for a balance-sheet which shall be a matter of veracity in its assets rather than of book-keeping could not be more clearly put. But there is no more reason for writing down the figure taken for office furniture to its real value than for the similar treatment of every other asset. Office furniture wears out, and has some day to be replaced. So does everything else. The rapidity of the process varies enormously, but no asset in which mankind has ever sunk capital is going to be reproductive for all time.

"When a Company," proceeds Mr. Pixley, "has been formed for the purpose of acquiring and carrying on an established business, the consideration may be either money, shares (fully paid up or otherwise) or partly money and partly

shares. In any case the consideration can only be entered in the Books of Account as if it were paid for in cash, under some appropriate heading, such as that in the margin (Purchase of Business, Goodwill, etc.). So long as the company is prosperous and its shareholders receive a satisfactory dividend, this Account is apparently as good an asset as a realizable investment, but in the event of the Company going into liquidation the greater part, if not the whole, of its value at once disappears. . . . It is, therefore, very desirable, instead of dividing all the profits among the shareholders, for a sinking fund to be raised, so that at the end of a certain period this Account may be either written off, or be reduced in amount to a saleable value. If this plan be adopted also with other Accounts, representing expenditure, and they have by that means been abolished, the shareholders will eventually have their money invested in realizable securities. . . . The foregoing remarks apply to all Companies whose capital or part of it has been expended in the acquisition or establishment of the business to carry on which it has been formed. For example: the capital of a Manufacturing Company is partly required either for acquiring the building, plant, machinery, and goodwill of an established business or in erecting the necessary buildings, purchasing the plant, etc., and creating a market

for the sale of its manufactures. . . . Although the Memorandum and Articles of Association of a Company may authorize the payment of dividends without providing for the return of capital expended on what is termed a wasting asset, it is distinctly unwise and unbusinesslike to take advantage of such a power." *

Here we find that this distinguished authority in actual practice advocates the highest and most austere ideal in the matter of treatment of the "assets representing expenditure." In the case of office furniture he is positive and peremptory; in that of buildings, plant, machinery and goodwill, purchase of business, preliminary expenses, etc., it is "very desirable" that they should be written off or reduced to a saleable value, out of profits. He even contemplates the carrying of this principle to its fullest possible extent until shareholders will eventually have their money invested in realizable securities. That is to say, the business and the plant, etc., will have been written down to nothing, the shareholders' capital will be represented by cash and marketable securities, and they will still possess their plant, factory and business working away for them and earning them profits. And so, when he comes to laying down rules for what is practically desirable, he goes very much further than those theoretical critics who merely

* pp. 480–1.

suggest that the assets of a balance-sheet should be brought into some relation with the prices that they might be expected to fetch.

It may be that this apparent divorce between the theory expounded by auditors and the excellent practical advice that the best of them give, arises from the respect that they feel for the legal aspect of their duties as expounded by the legal authorities. It is difficult to see why any one with any practical experience of business should take the law of the matter as a guide. The law is a very cumbrous, slow and inefficient machine for preventing robbery and other crimes on the part of rogues and burglars in the various forms in which they infest society. It makes no attempt to show us how things should be done well. That is not its business. Any one who relies on the merely legal interpretation of his duties is only doing enough to keep him out of Wormwood Scrubs. On this particular question of the manner in which the assets of a company should be treated, and of how far it can be said to be earning profits if it is not making provision for the reduction of the book value of assets to the point of realizable value, the law—as might be expected—is particularly fatuous, inconsistent and incorrect.

Let us take a few examples from legal judgments quoted by Mr. Pixley.

"The Goodwill of a trading Company is fixed

capital, and in ascertaining profits it is not necessary to make good any depreciation in respect of it." *

"Where nominal or share capital is diminished in value, not by means of any improper dealing with it, but by reason of causes over which the Company has no control, or by reason of its inherent nature, that diminution need not, in my opinion, be made good out of revenue." †

"Fixed capital may be sunk and lost and yet the excess of current receipts over current expenses may be applied in payment of a dividend." ‡

"Profits may be taken here to mean the surplus of income after defraying all, at least necessary, expenses of making it." §

"Profits for the year, of course, mean the surplus in receipts after paying expenses and restoring the capital to the position it was in on the 1st January in that year." ‖

All this, of course, is excellent good law, but most of it is monstrous bad finance, and its vagueness and inconsistency are at once glaringly evident. It need not be said that Mr. Pixley himself rejects legal authority altogether as a practical guide. In commenting on the second excerpt given above he remarks that this "decision of the Court of Appeal relieves the Auditor of responsibility . . .

* p. 423. † p. 425. ‡ p. 517.
§ p. 515. ‖ *Ibid.*

but it is certainly his duty to point out to the Directors that to declare dividends without creating a reserve for wasting property is a suicidal policy and contrary to the practice of soundly managed public Companies." Here again he flouts a legal doctrine, which he himself frequently quotes, that "it is no part of an Auditor's duty to give advice, either to Directors or Shareholders, as to what they ought to do. . . . It is nothing to him whether the business of a Company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the Shareholders. His business is to ascertain and state the true financial position of the Company at the time of the audit, and his duty is confined to that." * It need hardly be observed that this legal view of the auditor's business, which reduces his functions to those of a mere checking-clerk, is disregarded by Mr. Pixley in many passages in his book besides the one already quoted, and also by the practice of the best auditors, who often call attention to weaknesses in balance-sheets by remarks made in the course of the certificates that they append.

It may be considered that all this discussion is very theoretical and that as long as a Company is earning good profits and paying good dividends to

* p. 397.

its shareholders, the prices that it writes opposite to the assets in its balance-sheet are a matter of little moment. In fact, however, the question is extremely important, and the policy which is here advocated, of reducing the prices put on the assets to their realizable value, or the more austere ideal suggested by Mr. Pixley of writing them off altogether and having the capital of the company represented by realizable investments, is found in practice—as far as any examples of it are to be discovered—to bring a handsome reward to those companies which cultivate it.

The best financed companies that the joint stock system has brought into existence are, as might be expected, those which depend for their livelihood on their credit, and on their power to show an impregnably strong financial position, namely banking and insurance companies. And they are also those which earn the most regular and substantial dividends. No bank or insurance company can afford to show anything as an asset in its balance-sheet which could not be relied on to produce the sum at which it is priced. If it takes over a business, any consideration for goodwill is immediately written off. Any special loss is treated with the same ruthless severity. Provision for bad and doubtful debts is on a most liberal scale, and the premises account is written down in a Draconian spirit of which the most striking example is that of

the Bank of England, which does not value its enormously valuable site at one farthing among its assets. The result of this policy is, that the dividends earned by the banks and insurance companies are in most cases far above those that the most prosperous industrial companies can muster. It would not be fair to attribute the whole of this result to the austere finance which is dictated by the circumstances under which banks and insurance companies work Part of the comparatively big profits that they earn is due to their working with huge amounts of other people's money, a small profit on which means big dividends on their relatively small capitals. But there can be no doubt that their need for unblemished credit, and the consequent necessity that compels them to carry no assets in their balance-sheets except real assets, realizable at or above the prices at which they are valued, has been of the greatest possible assistance to them in establishing the earning power which is the envy of less well-financed concerns.

Theoretical and academic as it may appear, this question of the treatment of the value of assets in a balance-sheet is at the root of most of the bad finance that has dogged the careers of public companies since the limited liability laws made them popular. To show how the matter works in practice, let us imagine two joint stock companies

starting on opposite sides of the street, with £50,000 capital, invested in land, building, plant, machinery, goodwill, and stock-in-trade. Both earn a net profit of £5000 a year for ten years. One of them, Bad Finance, Ltd., pays away all its profits in 10 per cent. dividends. The other, Good Finance, Ltd., pays 5 per cent. dividends, and devotes £2500 a year to writing down its assets. At the end of ten years, Bad Finance finds that its plant and machinery are out of date, its goodwill is worthless, because its products are third rate, its earning power is rapidly diminishing, and its stock-in-trade could not be sold for half the price at which it stands in the balance-sheet. Its rival has been able to keep plant and machinery constantly replaced; has written down its land and buildings, and holds cash and securities, which are earning it an income, in place of the value that it has taken off them; has written off goodwill altogether, and replaced it with income bearing securities, and holds its stock-in-trade at a price which ensures it a handsome profit, however the market in its products may fluctuate. The income on its investments and cash deposited enable it to increase its dividends, which can be further enhanced by the distribution of a larger proportion of its profits when once its position has thus been secured. So the hard practical fact emerges at the end of this apparently academic discussion, that the way to earn dividends

is not to pay them, but to devote, especially in the early years of a company's existence, a large proportion of the profits to writing down assets.

The position of an auditor of a joint stock company is doubly difficult, from the indefinite and hazy nature of his duties, and from his relation to the shareholders and the Board. As we have seen, his duties are reduced by legal pronouncements to those of a checking-clerk, and the fees that he receives are very inadequate to the real importance of his task; while in practice, if a company gets into difficulties, the auditors are always likely to be blamed for not having pointed out that its published figures, though correct, were not veracious. Though originally, as a rule, appointed by the Board, the auditors are supposed to be watch-dogs in the interests of the shareholders, to see that the Board and the officials are publishing true and correct statements. Their duty is to the shareholders, but their direct relations are with the Board and officials. When they take a high view of their duties, and call attention in their reports to matters which ought to be amended, it sometimes happens that their action is very foolishly resented by the shareholders, whose best interests they are trying to serve, and they are sometimes even removed from office for having done their duty well. If shareholders understood the matter more

thoroughly, they would support such auditors heartily. In order to increase this understanding, the next chapter will go more fully into the questions of companies' profits and of the writing-down process.

CHAPTER VI

DEPRECIATION AND PROFITS

In the last chapter an attempt was made to explain at least the superficial meaning of the more obvious features of a company balance-sheet, and to show that nearly all balance-sheets of industrial companies are to some extent unsatisfactory, because of the lack of connection between the prices at which many of the assets are valued and those which they would be likely to fetch if realized. According to legal pronouncements, and the theory of the matter as laid down by high auditing authority, the realizable price of an asset has nothing to do with the price at which it appears in a balance-sheet. Common sense, common veracity, and the practice of good finance as laid down by high auditing authority, all decide that to price a wasting asset in a balance-sheet at the figure which the company originally paid for it, without regard to its realizable value, is misleading, absurd, and likely to lead the company straightway to disaster. We found Mr. Pixley expounding an ideal

under which a company would write off all its "accounts representing expenditure" and eventually the shareholders would have their money invested in realizable securities. For this purpose he suggested that a sinking fund should be raised, that is to say, if I understand him aright, that a certain amount should be set aside each year out of the profits of the company for the extinction of wasting assets. This periodical draft on profits is perhaps more commonly spoken of as a depreciation fund, and the necessity for generous treatment of depreciation, at the expense of the dividends to be distributed to shareholders, has been explained by Mr. Pixley in a masterly passage, which I take leave to quote in full :—

"Before finally settling the Profit and Loss Account, the question of allowances for depreciation has to be considered, and this is a most important matter, and fraught with great responsibility and liability on the part of the Directors, Secretary, and Officials. Certain assets, such as leasehold property, concessions, and patents, become of less value each year solely through effluxion of time, while plant and machinery, stock-in-trade, tools, fittings, furniture, etc., gradually lose their value, more or less, according to the manner in which they are used. For this reason no Company can be said to have made a fair profit until, in addition to the expenses of its business,

there has been charged against the revenue a proper amount for depreciation in respect of this class of assets.

"The usual method adopted for arriving at this amount is to take a percentage on the original cost price, and it is evident that this can only be properly done by dividing these assets into various groups, the items in each approximating, as near as possible, to the number of years they will respectively last. In the case of long leaseholds and heavy plant and machinery, the depreciation will of course be very small, as compared with that of short leaseholds, tools, driving bands, and other small articles in everyday use.

"A frequent method of arriving at the total amount to be written off for depreciation is the one which is, perhaps, the most thoroughly unsound which could be devised, viz., first ascertaining the profit without depreciation, then taking into consideration the amount of dividend which the Directors desire to pay, and leaving any balance available as the proper amount for depreciation. A more mischievous and unsound system could not be acted upon, or, from the Directors' and Officials' selfish point of view, a more foolish one. The object of Directors and Secretaries ought not to be to pay as high a dividend as possible, but to do exactly the reverse. A percentage on the capital paid away in dividend can never be recalled, while one

retained in hand is always available. A Director who consents to agree to recommend a quarter per cent. more dividend than he is absolutely compelled is exceedingly foolish, while a Secretary who assists him is more foolish still. There is no doubt that thousands of Companies registered since the Act of 1862 came into existence have been wound up through this insane craze for paying high dividends, when lower ones would have contented the shareholders and preserved their capital for a longer period.

"It may be argued that the Directors have no right, by writing off too much for depreciation in any one year, to minimize the profit of that year, and thus deprive shareholders, who may happen to be shareholders when the dividend is prepared, and who may sell their shares afterwards, of that which they are legitimately entitled to. This theory is, surely, an entirely false one; it is not incumbent upon the Directors to consider in any way individual shareholders, or a special group of shareholders and certainly not those who make a practice of buying and selling shares and holding them for short periods. It is their duty to keep the capital of their Company intact, and do their best to make it a permanent institution. With this view Directors and Secretaries should endeavour to eliminate the fictitious Assets from their Balance Sheets as soon as possible, and to replace them

by investments which in bad times will enable them to pay a moderate dividend. In frequent instances Companies, after paying dividends of fifteen and twenty per cent. for years, have gone into liquidation within twelve months of their last high dividend through their not having in hand a reserve out of which to meet a temporary depression in their particular line of business." *

It is commonly asserted that the shortcomings of joint stock companies on this important question of depreciation and writing down are in marked contrast with the practice of private firms. This contention I have heard maintained by authorities so well qualified to judge that it must be accepted as generally true, but I venture to think that the inference usually drawn from it—that the bad practice of joint stock companies is due to the ignorant cupidity of shareholders—is rather unfair to shareholders. Mr. Pixley in the passage quoted above lays the blame on the Directors and officials, and it may be noted that the higher ideal followed by banks and insurance companies has never been questioned by the proprietors, and has in fact been emphatically endorsed in a most practical manner by the outside public, which has bought bank and insurance shares at prices so high that the yield on them becomes comparatively low,

* "Duties of Auditors," Tenth Edition, pp. 356–7.

in spite of the big liability * which is usually carried by their holders.

But whether the fault be that of the Directors or of the shareholders is not a very important question. As Mr. Pixley shows, the policy of starving the depreciation fund in favour of dividends is an extremely foolish one from the point of view of the selfish interests of the Directors and officials, since it is likely to lead to the collapse of the company from which they draw fees and salaries; and from that of the shareholders it is almost equally unwise, since it is little comfort to them to remember that they have received and spent fat dividends, when the result of their having done so is the loss of their capital.

Unfortunately the amount of dividend paid by a company is too often taken as the only test of its welfare, and since dividend and depreciation are the two chief competitors for the balance of net profit, the temptation to pamper dividend at the expense of depreciation is a powerful influence on the side of bad finance.

Since depreciation and dividends can only be provided out of net profit, let us see, before we pursue the subject further, how net profit is

* That is to say, bank and insurance shares are in most cases only partly paid up, and in the event of the liquidation of the company, shareholders would have to pay considerable sums, if the company's assets were insufficient to meet the claims of creditors.

arrived at. The statements given by joint stock companies of their Profit and Loss or Revenue Accounts are infinitely various, but the basis of all, in the case of manufacturing or trading companies which produce or provide some tangible commodity for sale, is essentially the same. Their profit is arrived at by taking the value of the stock-in-trade with which they began the year, or whatever the period may be that is covered by the accounts, as the starting-point. This is clearly what they had in hand, from the trading point of view, at the beginning of the year and have to account for; and if we add to this the amount spent during the period on buying other material and working it up for sale, we shall arrive at the total of the company's trading material to be accounted for; against these figures we have to set the amounts received, or owing to the company, through sales, and the stock in trade which the company possesses at the end of the period, and these complete the company's trading receipts and stuff in hand, which should of course, in case of a prosperous company, be larger than the cost of the trading material, leaving a balance over it, which constitutes what is generally called the company's gross profit.

It will be observed that the delusive item, stock-in-trade, the difficulty of valuing which has already been referred to in discussing the question of the

assets of a balance-sheet, comes forward again here, and makes the question of the profit of a trading company which must have a certain amount of stock in hand, difficult to gauge at its very outset. Any laxity or optimism on the part of the managers and officials in taking the stock and valuing it may make a great difference to the extent of the profit, to say nothing of the happily rare occasions on which the item of stock-in-trade is used as a weapon for the perpetration of fraud. In the case of a company the accounts of which are before me, the item of stock-in-trade stands in the balance-sheet at £352,000, and the total net profit is £53,000; so that if the officials of the company were too cheerful in their estimate of the value of the stock to the extent of only 10 per cent., more than half the net profit would be shown to be fictitious Auditors are not expected to be valuers, and though they do their best to check the estimate put on the stock-in-trade by the officials of the companies whose accounts they examine, they have to depend largely on the figures supplied to them. All that the shareholders can do is to watch this dangerous item, and compare it year by year to see that it does not grow too big. If it does, it is either being over-valued, or the company's turnover is sluggish, and it is accumulating unsold goods too fast.

All this preliminary process by which gross profit is arrived at is generally omitted in the published accounts. Returning to the profit and loss account of Babcock & Wilcox, we see that it takes credit for a manufacturing profit of £366,000 odd, and tells us that a long string of items have been written off it, or charged against it before it was arrived at. The curious inquirer would like to know how much was charged for each, but Messrs. Babcock & Wilcox do not encourage curiosity in this respect. It also shows receipts for interest, etc., and for the fees which companies charge for registering transfers of their shares. The total receipts are thus £393,000. Against these gross receipts the account charges rent, rates, taxes, directors' fees, income tax, etc., and finally strikes a profit balance of £360,000.

In the profit and loss account of J. Lyons & Co., Ltd., which is appended on the following page, the item gross profit is the starting-point on the credit side of the account, and stands at more than a million.

In this case, gross profit presumably represents the difference between the price which these popular caterers paid for the goods they bought and the labour which they expended on them, and the price at which they sold them, cooked and dished up, to their hungry customers. It will be noted that special Exhibition expenses

have been deducted, and their amount is not stated. The other item on the credit side, interest and transfer fees, represents interest received by the company on its investments and cash deposited, and the fees earned for the registration of transfers of its shares. Its gross profits shown thus amount to £1,115,880 15*s.* 6*d.*, and against them is set off the big item of salaries, wages, rents, rates, repairs, maintenance, horsekeep and other expenses, amounting to £827,811 9*s* 3*d.*, leaving a balance of £288,069 6*s.* 3*d.*, which is carried to the credit side of the second account given below. This balance, with the amount brought forward, is now offset by depreciation and debenture interest, and £207,474 0*s* 5*d* is finally carried to the balance-sheet as net profit.

J. LYONS & CO.

Profit and Loss Account for the Year ending 31st March, 1910.

	£	s	d		£	s	d
To Salaries, Wages, Rents, Rates, Repairs, Maintenance, Horsekeep, and other expenses	827,811	9	3	By Gross Profit on Trading, etc. after deducting Special Exhibition expenses, to 31st March, 1910	1,110,488	9	10
Balance carried down	288,069	6	3	By Interest and Transfer Fees, etc.	5,392	5	8
	£1,115,880	15	6		£1,115,880	15	6

	£	s	d		£	s	d
To Depreciation . .	72,946	10	10	By Balance from last year	13,833	1	8
To Debenture Stock Interest	21,481	16	8	By Balance being Profit for the Year ending 31st March, 1910 ..	288,069	6	3
To Balance carried to Balance Sheet .	207,474	0	5				
	£301,902	7	11		£301,902	7	11

Many volumes might be filled, however, by examination in detail of the varying forms in which companies show or veil the results of their operations. But perhaps enough has already been said to bring out the glorious uncertainty that must always remain in the minds of all inquirers who try to peer behind the figures in search of facts. This uncertainty arises from three main causes—stock-in-trade, repairs and upkeep, and depreciation. No one can be certain that stock-in-trade has been taken at figures which are justified by the facts of the moment, when the accounts were made up; and if certainty were attainable on this point, there is always the possibility that a change of fashion or a bad season may make part of it unsaleable, and reduce the valuation of the rest to a vanishing dream. No one can be certain that repairs and upkeep of premises and plant have been adequately dealt with. No one can be certain that sufficient provision has been made for depreciation and obsolescence. Hence the conclusion emerges that company accounts are an alluring mirage in which various attractive and solid-looking items are piled up before the eyes of the gazer, with labels attached bearing legends that indicate certain pounds, shillings and pence as their value; then there may come a change of atmosphere, or a touch of "envious sneaping frost" in the air, and the whole fairy structure shimmers into space.

The Gigantic Wheel, priced in its balance-sheet at £30,000, fetches £300 on the scrap heap, stock-in-trade may be found to have been fraudulently counted twice over, or quite honestly over-valued to an extent which spells ruin, sundry debtors may prove to be for the most part insolvent and requiring to be written off as bad debts, buildings have to be rebuilt, plant and machinery to be replaced, and goodwill as a tangible asset is found to be mere moonshine. These things do not in practice often happen all at once, but one or other of these disillusionments is likely to be appearing more or less at all times, and it is because the best arranged figures of company accounts give one no real clue to tracing them, that the assets side of a balance-sheet is a glorious game of make-believe, unless and until it has been treated according to Mr. Pixley's prescription, by the abolition of all "fictitious assets," and their replacement by securities and cash.

And now, after all this digression, we are in a position at last to see how this business of the abolition of fictitious assets has to be worked, that is to say, what writing down really is in practice. We will simplify the inquiry by inventing a company and drawing up accounts for it, and also endowing it with a lofty ideal in the matter of depreciation. Or rather we will return to Good Finance, Ltd., which we have already

imagined (p. 150) as a copybook example of financial piety. We endowed it with a profit of £5000, out of which it devoted £2500 to depreciation, and we will now compose a profit and loss account for it.

	£		£
Rent, rates and taxes, repairs	3,000	Gross profit	10,500
Salaries, wages, general expenses	2,500		
Depreciation	2,500		
Net profit	2,500		
	£10,500		£10,500

It will be observed that the difference between the gross profit and the total expenses was £5000, but that instead of calling the whole of this net profit, the Directors devoted £2500 of it to depreciation. In order to see the effect on the balance-sheet let us first draw out one showing the company's position when it acquired its business.

ORIGINAL BALANCE SHEET

LIABILITIES	£	ASSETS	£
Capital paid up	50,000	Freehold land and buildings	20,000
		Plant and machinery ...	8,000
		Goodwill	12,000
		Stock-in trade	5,000
		Preliminary expenses ...	1,000
		Cash in hand	4,000
	£50 000		£50,000

By the end of the first year we suppose it to have made a profit of £5000, out of which it takes £2500 for depreciation. In order to trace more

clearly what would happen to this depreciation money let us first draw up balance-sheet No. 1, showing what the position would be if depreciation were ignored and the whole sum were treated as divisible profit.

	£		£
Capital	50,000	Freehold land and buildings	20,000
Sundry creditors	2,500	Plant and machinery ...	8,000
Profit and loss balance ...	5,000	Goodwill	12,000
		Stock-in-trade	5,000
		Sundry debtors	2,500
		Preliminary expenses ...	1,000
		Cash in hand	9,000
	£57,500		£57,500

In the course of its trading the company has both given and taken credit, and so the item, sundry creditors, appears as a liability and sundry debtors as an asset; for the sake of simplicity, I have made these items balance. As the total profit before allowing for depreciation is £5000, we thus find that its cash should be increased during the year to £9000, since, again for clearness and simplicity, I have supposed that the stock-in-trade item has not been altered. But since it has decided to devote £2500 to depreciation, let us see what effect this self-denial will have on the figures and how the £2500 will be used. Some of it will certainly be devoted to writing down the preliminary expenses, that is the money spent in advertising, stamps, etc., necessary for the provision of the company's capital and starting it as a joint stock concern. It

is a modest sum, but the whole concern is on a small scale. Since this is clearly the most fictitious of the fictitious assets, as there is no possibility that the sum could be under any circumstances recovered, it is desirable that it should be quickly abolished, and the Directors will write off the whole of it at once; plant and machinery they will write down by 10 per cent., that is, reduce the item £8000 by £800; land and buildings will require less drastic treatment, since freehold land in a well-chosen site should not depreciate, and the buildings are a much more permanent asset than machinery and plant; nevertheless, the Directors may fairly decide to take £700 off them, leaving goodwill alone this time and meaning to attack it vigorously next year when there are no longer any preliminary expenses to be handled. After depreciation has been applied in this manner, balance-sheet No. 2 will stand thus:—

	£		£
Capital	50,000	Land and buildings, £20,000, less depreciation £700	19,300
Sundry creditors	2,500	Plant and machinery £8000, less depreciation £800	7,200
Profit and loss balance ...	2,500	Goodwill	12,000
		Stock-in-trade	5,000
		Sundry debtors	2,500
		Preliminary expenses £1000, less written off £1000	—
		Cash in hand	9,000
	£55,000		£55,000

The result of these movements is that the profit and loss balance available for distribution among shareholders has been reduced by £2500, and on the other side of the account veracity has been aimed at by the complete elimination of a fictitious asset, and by a beginning of the reduction in the prices at which wasting property is valued. At the same time, less cash will be paid away to shareholders and more will be retained by the company, to be held or invested; for by this process there is only £2500 instead of £5000 in the final profit balance carried to the balance-sheet, out of which dividends can be declared. Consequently, the draft on the company's cash, in supplying income to shareholders, is to this extent limited. If instead of these sums being written off, £5000 were carried to the balance-sheet as profit and paid away in dividends, the result would be that the assets would be left as before, and the company would rejoice in a balance-sheet in which no attempt had been made to substitute facts for labels, and a bank balance smaller by £2500. But it may be urged, What is the use to shareholders of a strong balance-sheet if it does not produce good dividends? If any one asks this question seriously, I will first of all ask him to read again the golden passage from Mr. Pixley, quoted on pp. 154–7, and will then invite him to consider the further history of this imaginary company by looking at balance-sheet No. 3, of ten

years later, which we will construct on the assumption that the company has continued to write off £2500 a year and that its stock-in-trade, creditors and debtors have remained at the same figures.

BALANCE-SHEET No. 3

	£		£
Capital	50,000	Land and buildings £20,000, less depreciation £6500	13,500
Sundry creditors	2,500	Plant and machinery £8000, less depreciation £8000	—
Profit and loss balance . .	3,500	Goodwill £12,000, less written off £12,000 ...	—
		Stock-in-trade	5,000
		Sundry debtors	2,500
		Preliminary expenses £1000, less written off £1000	—
		Investments	30,000
		Cash in hand	5,000
	£56,000		£56,000

A shareholder in the company would not only be rewarded for his self-denial by the academic pleasure—which he might properly regard as quite empty and unsatisfying—of being able to look at a balance-sheet which is a picture. He would see that goodwill had gone after preliminary expenses and been eliminated altogether, that plant and machinery had been written down to nothing, and that land and buildings had been brought down to what may be supposed to be their scrap-heap value. He would also see that the company is in a position to replace its machinery, which probably by this time

requires it, and has got cash and investments in hand out of which it can very easily be done. Moreover, he will see that the profit and loss balance is now £1000 higher, although we have not supposed any increase in the company's earnings, because the cash kept from him by the writing off process has been invested, and more besides, since the company has no need to keep a large amount at its bank, where it can borrow readily if it happens to need cash, on the security of its investments. Consequently it holds £30,000 of investments, following Mr. Pixley's ideal, and first-class gilt-edged stocks will easily yield it a full 3½ per cent., and so return it £1000 a year, even when the tax-gatherer has taken his bite out of the income. Thus the company is in a position now to pay 7 per cent., without any increase in the earning power of its business, although, since good finance generally exercises a subtle influence on management, it is fairly safe to expect that a company which had performed these feats with its balance-sheet would in the mean time have been improving its business. Moreover, we see now that the point has arrived at which depreciation on this scale need no longer be continued. Henceforward if the company writes off £1000 a year it will be doing more than ample justice to the position, so that while its income on investments increases, its drafts on profits for depreciation decrease, until

finally the time comes when it is compelled to pay away in dividends all that it earns on its business and on its investments.

It may be objected that it is absurd for a trading company thus to turn itself into an investing corporation, and that the holding of gilt-edged securities is not its real business, which would have been better furthered by expenditure on development. For the sake of simplicity this imaginary example has dealt with a company with a more or less stationary business, though in actual life a stationary business is generally found to mean sleepy management which finally leads to decay. This was done in order to show the effect of austere finance, and strict attention to the claims of depreciation, taken by themselves and apart from any increase in industrial earning power. But in order to complete our review of the possibilities of the matter, it may be as well to construct balance-sheet No. 4, showing what the company might have done if instead of investing the sums kept in hand for depreciation in securities, it had used them in the expansion of its industrial earning power. In the eleven years of its existence its balance-sheet will have been modified as follows, as compared with the original starting-point drawn up on p. 165 :—

BALANCE-SHEET No. 4.

	£		£	£
Capital	50,000	Freehold Land and Buildings ...	20,000	
Sundry Creditors	2,500	Plus additions ...	20,000	
Profit and Loss Balance ...	7,500		40,000	
		Less depreciation	6,500	33,500
		Plant and Machinery	8,000	
		Plus additions ...	7,500	
			15,500	
		Less depreciation	8,000	7,500
		Goodwill	12,000	
		Less written off	12,000	
		Preliminary expenses	1,000	
		Less written off	1,000	
		Stock-in-trade	...	5,000
		Sundry Debtors ...	...	2,500
		Cash in hand ...	...	11,500
	£60,000			£60,000

In this case the company in the course of its existence has retained as before £27,500 out of profits for depreciation, and has put it into the business by additions of £20,000 to land and buildings and £7500 to plant and machinery, goodwill and preliminary expenses having been at the same time eliminated. But the original cost of its original land, building and plant machinery, the assets on which its earning power was really based was £28,000, and so by this self-denying policy it has been able, out of revenue, to double its earning power if we suppose that the additions have been as efficacious in profit-making as the original

factory and plant. Consequently we can reconstruct the company's profit and loss account thus:—

	£		£
Rents, rates, taxes, and repairs	6,000	Gross profit	21,000
Salaries, wages, general expenses	5,000		
Depreciation	2,500		
Net profit	7,500		
	£21,000		£21,000

The £27,500 written off is not quite the original £28,000, but since the expansion of the business has been probably accompanied by some relative cheapening in expenses, we are probably within the mark in assuming a margin, on the new basis, of £10,000 between the gross profit and the charges against it, before depreciation is allowed for. Thus it appears that the company, having doubled its earning power out of revenue, is in a position to pay 15 per cent., though it would probably be better for it to add slightly to its annual allocation to sinking fund in view of the increase in the assets of a more or less wasting nature that it now possesses. This expansion policy, by which funds retained for depreciation are invested in the business instead of in securities, is in some respects the more attractive, since it implies a lively spirit of enterprise and greater earning power as

long as the business expands in profit as well as in volume. But it is evidently less safe than the other, since the self-denial of the shareholders has committed them more deeply in the business, and if a spell of bad trade or any other misfortune overtook the company, the fact that they had been putting more and more eggs into one basket would make the breakage all the more serious. Probably the best policy of all is a judicious mixture of the two, by which part of the depreciation fund is devoted to the expansion of the business, and part to the acquisition of securities from which an income may be received, whatever be the ups and downs of the enterprise.

There is yet another system for dealing with funds retained out of profits, though it differs from those examined above in a mere question of book-keeping detail. By it, the funds received are not written off the assets but are added to the liabilities in the shape of a reserve fund. That is, instead of the fictitious and wasting assets being replaced by securities or new assets, they are left standing at the original values, and there appears among the liabilities an entry, reserve fund, which is represented on the other side either by investments, or new buildings and plant, according to the policy adopted, of expansion or investment. On this principle we reconstruct balance-sheet No. 3 given on p. 169, thus:—

	£		£
Capital	50,000	Lands and buildings ..	20,000
Reserve Fund ...	26,500	Plant and machinery .	8,000
Sundry creditors	2,500	Goodwill	12,000
Profit and loss balance ..	3,500	Stock-in-trade	5,000
		Sundry debtors	2,500
		Preliminary expenses £1000, less written off £1000	—
		Investments	30,000
		Cash in hand	5,000
	£82,500		£82,500

I have written off the preliminary expenses, because no self-respecting company could endure such an entry for eleven years, but otherwise the assets have been left at their original figures. The £1000 taken for writing off preliminary expenses has thus reduced the amount of the liability on reserve fund to £26,500 instead of the £27,500 which has been retained during the eleven years of self-denial practised by the company. This reserve fund policy, or a mixture of it with the writing down system, is the usual course followed by companies which are sensible enough to set aside part of their profits regularly. It is more striking to the eye and shows more clearly than the writing off plan what the company is doing in the matter of self-denial, and consequently earns more general approbation and eulogy from critics. In fact I have known a case in which a company made drastic allocations to writing down its assets, and was then reproved by a censorious

Mentor because it distributed the rest of its profit balance in dividend and placed nothing to reserve. He accused it of dividing up to the hilt, whereas about one-third of its profits had been devoted to writing down.

Nevertheless, though the reserve fund policy is thus more showy and effective, it carries with it the fault that it leaves wasting assets unreduced, and unreal assets, such as goodwill, unabolished, and the balance-sheet is to this extent based on fancy rather than fact. It also has this disadvantage, that it encourages naughtiness when a large reserve fund is piled up, and makes folk who think only of the immediate advantage of the present shareholders and not of the enduring strength of the company, bring forward proposals for the distribution of the reserve fund by way of bonus, or for its capitalization and distribution in the form of stock.

This capitalization of reserves does not do a company any real harm because it merely converts a liability from one form into another, and does not involve parting with any cash. It is a mere bookkeeping frippery, by which the reserve fund is wholly or partly abolished, and the capital of the company is watered by the amount taken from reserve. Shareholders are pleased by the fact that they are given a large nominal addition to their stockholding, but since the company's earning

power cannot by any possibility be increased by such a transaction, the proprietors are only benefited if the outside public happens to be misled into a delusion that the shareholders are really getting something solid and rush to buy the stock. Such an operation was recently carried out by no less a company than Arthur Guinness, Son, and Co., Ltd., which being possessed of reserve funds amounting to £2,870,000 used £2,500,000 of them in watering the capital to that extent, and so doubling its amount. The result was that the company had twice as much capital to pay dividends on, while its income only grew with the normal increase of this well-managed property's earning power. Consequently, the dividend which was 27 per cent., including bonus, before watering, was 14 per cent. after it. The operation may be justified in the case of Guinness, because it was one of the few businesses that have been too modestly capitalized when sold to the public, but a captious critic might observe that before watering the capital the Directors might well have written off goodwill, so removing a blot from an otherwise attractive balance-sheet. But in this case the water put into capital was at least represented by assets, held against the reserve fund, which had been kept in hand out of profits. So that the transaction is quite sound and sensible, when compared with the tricks of financial legerdemain perpetrated by some

of the Home Railway companies, which have duplicated or increased their ordinary capitals, not by the capitalization of reserve funds, but by a mere stroke of the pen. The artificiality of the arrangement is shown by the fact that one company made no corresponding change in its assets, while another added over nine millions to them, though it need hardly be said, that there had been no increase in their value. As long as assets in a balance-sheet are dealt with in this pleasant imaginative fashion, the study of them may possess some academic interest, but gives no clue to the real position of the company that publishes them ; but the contrary policy, by which profits are drawn on year by year in order to bring the assets, by the writing down process, into some connection with veracity, is one which generally earns a handsome reward whenever the Directors of a company have the courage to carry it through consistently to its complete conclusion.

CHAPTER VII

GOVERNMENT AND MUNICIPAL SECURITIES

HAVING examined the birth and growth of joint stock companies and of the securities that they produce, we have to go on to the loans of Governments and municipalities. In the case of joint stock companies we found that in all of them there were two, and in many of them three, elements of uncertainty, which lurk behind the fairest figures in the most beautiful balance-sheet. There is the question of stock-in-trade, generally taken on the word of the company's officials and evading the scrutiny of the auditors, who cannot be expected to be valuers; then there is a possibility that inadequate provision has been made for repairs, bad and doubtful debts, and depreciation. A small and quite venial amount of natural and pardonable error on all these points may easily give an almost bankrupt company an appearance, from its accounts, of happy prosperity; and since, in theory at least, the accounts of a company only purport to show its position according to its own books, their interest is finally discovered to be chiefly academic.

When we proceed to the securities of Governments and municipalities the problem of their trustworthiness becomes much simpler and more straightforward, because it is much less complicated by misleading and meaningless figures. Governments and municipalities do not publish balance-sheets in the sense attached to the word when they are issued by joint stock companies, or profit and loss accounts, since the earning of profits is only a more or less irrelevant side-issue in their activities. And such accounts as they do publish are generally left unread and unexamined except by a few unfortunate experts who are expected to attempt to unravel their obscurities, generally with a view to supplying weapons for the armoury of party politics.

A general statement is usually made by the Finance Ministers of the various nations at the time of the introduction of the Budget or its equivalent, but as a rule this merely covers the requirements of the current period and the measures necessary for meeting them, and any really enlightening review of the financial position of the country as a whole would be, if delivered on such an occasion, an impertinent irrelevancy, obscuring the real question in hand, and confusing the minds of the electors or their representatives. The credit of nations, that is to say, the belief in the minds of investors that they can and will meet

their obligations, is and must be largely a matter of guess-work, and, this being so, it is perhaps in some respects better that it should be left unobscured by confusing and misleading figures, like those of a commercial balance-sheet, with little real connection, in too many cases, with the actual facts of the position.

In order to see how big a gap has to be filled in by the imagination of the inquirer, let us take the position of the British Government with regard to its assets and liabilities, in other words, let us draw up a balance-sheet for it. A publication called the "Finance Accounts of the United Kingdom" gives us figures, as on March 31, 1909, out of which we can construct the following edifice * :—

Liabilities	£	Assets	£
Funded debt ...	621,838,957	Suez Canal shares ...	32,667,000
Estimated liability on terminable annuities	38,009,337	Loan against bullion, etc.	650,000
Unfunded debt ...	42,839,003	Due from Colonies on Pacific cable ...	1,373,162
Other capital liabilities	51,433,412	Cunard debenture stock held as security for loan ...	2,470,000
		Cash in hand ...	6,350,427
		Apparent excess of liabilities	710,610,720
	£754,121,309		£754,121,309

These figures show an excess of liabilities

* I take the return for that year since the 1910 figures were abnormal in the matter of floating debt owing to the delay in the passing of the Budget.

over assets of no less than £710,610,720. The statement is incomplete but the net result is, perhaps, not very far from the mark. On the assets side no attempt is made in the Finance Account to take credit for the value of the fortifications, barracks, docks, Uganda railway and other items which have been procured for the British taxpayers by the expenditure of 51 odd millions represented under the title of "other capital liabilities." It is characteristic of official practice, which seems to adopt a different principle in each one of the forms in which it makes a financial statement, that a distinction is frequently drawn between this item and the rest of the debt, the latter being designated as deadweight debt, with the implication that this 51 millions has been spent on live assets; and yet in the estimate of the assets of the United Kingdom, given in this account, no mention is made of these items. Probably this is better book-keeping, for it is safe to infer that few, if any, of the objects for which the "other capital liabilities" have been raised are capable of producing a net revenue, so that their exclusion may be commended as good and austere finance. But why, this being so, the distinction between this liability and the deadweight debt? It is true that special provision has been made for the redemption of this liability, but that does not make its weight any more lively.

Other assets which are not included are the value of the Crown lands and the Post Office property. But against these omissions on the assets side, we have to put at least as serious gaps on the other side in the shape of certain contingent liabilities.

These contingent liabilities are mentioned in a footnote to the statement from which our figures are taken and are euphemistically described as matters "which the State is not likely to be called upon, to any material extent, to discharge." A list of them is given on a subsequent page in the account, and among other items we find, Post Office Savings Banks, Trustee Savings Banks, Friendly Societies. No figures are placed against these entries, but Mr Thomas Gibson Bowles, in a pamphlet entitled "National Finance in 1908 and After," calculates that the securities held by the State against its liabilities to depositors in savings banks and friendly societies fall short, when taken at market prices, by over 25 millions of the sum required to meet them. It need not be said that a system of book-keeping which makes no attempt to bring so serious a liability into account, would be considered highly reprehensible in any industrial company, and would shatter the credit of any bank or insurance society.

With the British Government, the case is other wise. This airy treatment of a loss does not hurt

its credit at all. This is naturally so, because, very fortunately for it, its credit does not depend on the manner in which it conducts its finance, but on the wealth and wealth-producing capacity of the inhabitants of these islands, and their readiness to tax themselves in order to meet a national emergency or make good a deficiency that has been ignored by the national book-keepers. Viewed in the light of this consideration, the 710 millions of debt represented by nothing tangible or marketable in the hands of the Government, become a matter which never causes a moment of serious reflection to 999,999 out of every million inhabitants of the country. The British Government, and the people who are nominally its masters, have a happy conviction that there is a bottomless purse behind it, and so are merely rather bored if any one alludes to the size of the debt, or perhaps rather proud of it as an achievement. Certainly it is a mighty achievement for a nation to owe so much, with nothing to show for it, and yet maintain so high a standard of credit; and we may at least claim that we make some attempt in time of peace to reduce this deadweight burden on our backs, of which, thanks to our collective financial strength, we are hardly aware. But the pace of redemption is lamentably slow, the Sinking Fund is too often raided by Chancellors of the Exchequer of both political parties, and the modern tendency

of finance seems likely to leave us with one of our keenest weapons against attack in a rusty and tarnished condition.

It is commonly claimed that there is another asset to be set against this huge figure of debt, namely the possession of the British Empire. But most of the British Empire is possessed, not by the inhabitants of these islands, who are collectively responsible for the debt, but by the inhabitants of the countries that compose it. We could not sell it if we wanted to, which is, as a matter of sordid fact, the chief test of an asset as set against a debt. It is not even as marketable as the goodwill of a commercial company. It is not a producer of revenue for the British Isles. The revenues that it produces are naturally spent by and for those who pay them. The Empire is a splendid heritage, but we do not make it more splendid by cherishing delusions about it. In fact, it is a drain on the revenues of the United Kingdom. In the course of the Colonial Conference of 1902 Mr. Chamberlain, then Colonial Secretary, told the assembled Colonial Premiers that "if the United Kingdom stood alone, as a mere speck in the northern sea, it is certain that its expenditure for these purposes of defence might be immensely curtailed." *

The common answer to this view of the

* Official Report of the Colonial Conference, June to August, 1902, Cd. 1299.

costliness of Empire maintains that we get back in trade what we pay in Imperial defence. There may be something in this contention, though it must be remembered that nearly three-fourths of our trade is with foreign countries. But even if we grant that the profits of Imperial trade make good the cost of Empire to the British Isles, this concession does not make the Empire a revenue producer for us, or allow us to regard it as an asset, in the strictly businesslike sense of the word —and business words ought to be used in their businesslike sense.

In a recent debate on the Budget, Mr. Asquith gave currency to this slipshod misuse of language by contending that the deadweight debt is represented by "the most considerable asset in the whole world—namely the British Empire."* He was effectively answered by Mr. Bonar Law, who reminded him that Germany had behind its debt "the German Empire and something else. It had liquid assets which could be sold in the market to-morrow. The amount of revenue which Germany derived from railways and other remunerative sources would pay from two-thirds to three-quarters of the whole Imperial debt of Germany. As to the debts of the German States, Prussia, which was the largest State, had the heaviest debt, amounting to £361,000,000. Two or

* *Times*' report of Debate on July 6, 1910.

three years ago the Finance Minister of Prussia laid before the Prussian Parliament a balance-sheet showing that the assets of that State, valued at the market price of the day, would be sufficient to pay off the debt and leave a balance of £900,000,000 in favour of the Prussian Government. It was within the mark to say that if Germany chose to sell those undertakings, all of which could be carried on by private enterprise, she could pay off the whole of her debt and have to her credit a much larger sum than our national debt."

Apart, then, from its Suez Canal shares, Crown lands, some barracks and docks, many of which are of problematical value and utility, Post Office property, and one or two minor items, the British Government has nothing to set against the huge amount that it owes except the taxable capacity of the people of two small islands. Since this taxable capacity is a figure that can be extended almost indefinitely in accordance with the optimism of the statistician who may happen to conduct inquiries, the gap between the debt and the tangible assets can be very comfortably filled.

As for the origin of this big gap between British revenue and expenditure in the past, it arose from wars waged at various times, and from the habit adopted by the statesmen of this and of all other countries of meeting a large proportion of the expenses of war out of borrowed money, and

leaving posterity to pay the bill. Posterity pays the interest and redeems the debt by minute instalments, except when it is in its turn engaged in piling up a bill for the posterity that comes after it. Most of the wars to which England owes its debt were waged about some Continental question with which it had little direct concern, and much of the expenditure that produced it arose from the necessity, under which England's rulers imagined that they found themselves, of bribing Continental potentates to fight for their own existence.

Debt of this kind first came into existence under William the Third, who, being a Dutchman, was delighted to use England's wealth for the furtherance of his cherished policy, a European coalition against Louis the Fourteenth of France. Concerning this coalition let us take a few extracts from Macaulay, William's adoring historian. "Meanwhile the coalition . . . was in no small danger of falling to pieces from mere rottenness. Two of the allied powers, and two only, were hearty in the common cause. . . . England and Holland . . . were ready to bear their share, and more than their share, of the charges of the contest. Most of the members of the confederacy were not nations but men, an Emperor, a King, Electors, Dukes; and of these men there was . . . scarcely one who did not hang back, who did not find some excuse for omitting to fulfil his engagements, who

did not expect to be hired to defend his own rights and interests against the common enemy. . . . England and Holland . . . were persecuted with sordid importunity by all their confederates. . . . It was not enough that England and Holland furnished much more than their contingents to the war by land, and bore unassisted the whole charge of the war by sea. They were beset by a crowd of illustrious mendicants, some rude, some obsequious, but all indefatigable and insatiable. One prince came mumping to them annually with a lamentable story about his distresses. A more sturdy beggar threatened to join the Third Party and to make a separate peace with France, if his demands were not granted. Every Sovereign, too, had his ministers and favourites; and these ministers and favourites were perpetually hinting that France was willing to pay them for detaching their masters from the coalition, and that it would be prudent in England and Holland to outbid France. . . . The Elector of Saxony complained that bad winter quarters had been assigned to his troops; he therefore recalled them just when they should have been preparing to take the field, but very coolly offered to send them back if England and Holland would give him four hundred thousand rix dollars"*

Such were the allies in whose interests the

* "History of England," ch. xix.

English debt was founded. This war lasted from 1689 to 1697. By the terms of the Peace of Ryswick which ended it, Louis the Fourteenth gave up some of his Continental conquests, and acknowledged William as King of England; and England was left with a debt of 14½ millions and a revenue deficiency of five millions, to meet which more debt had to be raised.*

The next war was concerning the question of who should reign in Spain, which had offered its throne to Louis the Fourteenth's grandson in 1700. The Tories were then in power in England, and in those days the traditional Tory policy was insular, maintaining that England ought to leave Continental potentates to fight out their quarrels and rely on her navy for the defence of her shores and of her trade. Dr. Johnson, the living embodiment of eighteenth-century Toryism, expresses this insular view of foreign politics in a note to his edition of Shakespeare. In Henry VI. Pt. III. Act IV. sc. I., Hastings says—

> "Let us be back'd with God, and with the seas,
> Which He hath given for fence impregnable,
> And with their helps only defend ourselves;
> In them, and in ourselves, our safety lies."

"This has been the advice," says Johnson's note, "of every man who in any age understood and favoured the interest of England." Shakespeare

* Fenn on the Funds.

was echoing a sentiment of Queen Elizabeth's, who told Sully, as recorded in his memoirs, that the British Isles "had never suffered any reverse or serious misfortune save when their sovereigns had wanted to go outside their own little continent." * Disliking William's Continental policy, the Tories refused to be led into the quarrel which gave him a chance of another fling at his old enemy, Louis. But just at this moment James the Second, the deposed King of England, died, and Louis was stupid enough to recognize his son as James the Third, in defiance of the Peace of Ryswick. William took prompt and skilful advantage of this blunder, which enraged our testy ancestors into a proper pitch of warlike fury. He dissolved Parliament, and got a Whig majority eager for war with France. An accident killed him before he could take the field, but the war began which was carried on by Marlborough in the reign of Queen Anne. Carlyle, who alone among historians treats British foreign policy in the spirit of half-melancholy mockery that best fits it, sums up this war in these terms :—

"The English, always a wonderful Nation, fought and subsidied from side to side of Europe for this Spanish-Succession business; fought ten years, such fighting as they never did before or since, under 'John Duke of Marlborough' who, as is well known, 'beat the French thorough and

* Quoted by "The Arbiter in Council," p. 287

thorough. French entirely beaten at last, not without heroic difficulty and as noble talent as was ever shown in diplomacy or war, are ready to do your will in all things; in this of giving up Spain, among others:—whereupon the English turn round, with a sudden new thought, 'No, we will not have our *will* done; it shall be the other way, the way it *was*—now that we bethink ourselves, after all this fighting for our will!' And make Peace on those terms, as if no war had been; and accuse the great Marlborough of many things, of theft for one. A wonderful People; and in their Continental Politics (which indeed consist chiefly of Subsidies) thrice wonderful. So the Treaty of Utrecht is transacting itself; . . . and after such quantities of powder burnt, and courageous lives wasted, general *As-you-were* is the result arrived at." *

It should be remembered, however, that this Treaty of Utrecht secured for England the monopoly of the slave trade with Spanish America, and consequent rejoicings and Te Deums, referred to in Chapter I. It was signed in 1713. Queen Anne's reign ended in the next year, and at that date the national debt had risen to thirty-six millions.†

The next war was, ostensibly at least, about a business matter, namely the hard and ruffianly manner in which Spain treated English sailors who were infringing her trade monopoly in America.

* "Frederick the Great," Bk. iii. ch. 20. † Fenn.

The Treaty of Utrecht gave the slave trade to England instead of France, but otherwise confined our commerce with Spanish America to one ship of six hundred tons. This restriction was soon waste paper. "An immense illicit trade," says Lecky, "sprang up, which was for a time unmolested, but was afterwards met by a rigid exercise of the right of search on the high seas, and by the constant seizure of English ships, and it was accompanied on both sides by many acts of violence, insolence, and barbarity."* A chance arrived for the Opposition in England, who were tired of Walpole and his peace policy. A certain Captain Jenkins was brought before the House of Commons and alleged that he had been seized by the Spaniards while sailing to Jamaica and tortured and shorn of an ear; and his evidence roused our forbears with such effect that the consequent war is sometimes called the War of Jenkins' Ear. Later evidence threw much doubt on skipper Jenkins' story. It is not at all certain that he had lost an ear at all. Horace Walpole relates that when he was dead it was found that he was fully equipped with ears.† But public feeling was too angry to weigh evidence, and this war was stated by Burke, who condemns it on other grounds, to have been the only one waged by England in

* "History of England," ch. iii. vol. i. p. 449.

† Quoted by Lecky, p. 451.

the eighteenth century which was the "fruit of popular desire." His weighty remarks on it are worth quoting.

"In stating that Walpole was driven by a popular clamour into a measure not to be justified, I do not mean wholly to excuse his conduct. . . . I say this, after having seen, and with some care examined, the original documents concerning certain important transactions of those times. They perfectly satisfied me of the extreme injustice of that war, and of the falsehood of the colours, which to his own ruin, and guided by a mistaken policy, he suffered to be daubed over that measure. Some years after, it was my fortune to converse with many of the principal actors against that Minister, and with those who principally excited that clamour. None of them, no not one, did in the least defend the measure, or attempt to justify their conduct." *

Besides this question of the right of search, or, rather its abuse, we had other claims against Spain, and on the whole this war, which began in 1739, seems to have had more reason than most behind it. But its real origin was soon lost sight of and quite forgotten when, after adding 30½ millions to the national debt,† we made peace in 1748 by the Treaty of Aix-la-Chapelle.

* Burke, "Letters on a Regicide Peace."

† Fenn on the Funds.

In the meantime, the war had been mixed up with a general European scrimmage, and high and mighty diplomatists had forgotten what it was about. Venting his sardonic humour on the Peace of Aix-la-Chapelle, Carlyle observes that "There is not the least conclusion arrived at on that important Spanish-English-Question; blind beginning of all these conflagrations; and which, in its meaning to the somnambulant Nation, is so immense. No notice taken of it; huddled together, some hasty shovelful or two of diplomatic ashes cast on it, 'As good as extinct, you see!' Left smoking when all the rest is quenched. Considerable feeling there was, on this point, in the heart of the poor somnambulant English Nation; much dumb or semi-articulate growling on such a Peace-Treaty: 'We have arrived nowhere, then, by all this fighting, and squandering, and perilous stumbling among the chimney pots? Spain (on its own showing) owed us £95,000. Spain's debt to Hanover; yes, you take care of that; some old sixpenny matter, which nobody ever heard of before: and of Spain's huge debt to England you drop no hint; of the £95,000, clear money, due by Spain; or of one's liberty to navigate the High Seas, none!' A Peace the reverse of applauded in England; though the wiser somnambulants . . . may well be thankful to see such a War end on any terms." *

* "Frederick the Great," Bk. xvi. ch. iii.

Lecky, less picturesque and perhaps more convincing, points out that "The right of search, in opposition to which she [England] had originally drawn the sword against Spain, and the debt of £95,000 which the Convention of 1739 acknowledged to be owing to her by Spain, were not even mentioned in the peace. . . . No real compensation was obtained for a war expenditure which is said to have exceeded 64 millions." * As usual we continued our policy of paying Continental rulers to fight their own battles, and they took the money for their own purposes and then abused us. Lecky observes, concerning Maria Theresa, Empress of Austria, that "Like many absolute sovereigns she appears to have been completely indifferent to the misery and desolation she caused, provided only she could leave her empire as extended as she had received it. She was resolved to throw the defence of the Austrian Netherlands almost exclusively on the maritime Powers; she employed the subsidies which she received on the express condition of keeping a large army in those provinces, mainly in a war of aggression in Italy; and she was bitterly aggrieved because the English, under these circumstances, diminished their remittances."

The next item in the bill was the Seven Years' War, 1756–1763. This was a glorious European

* "History of England," ch. iv.

free fight in which all the great Continental Powers took part on one side or the other, or on both. We, as usual, were in the very middle of the fun, fighting, subsidizing and somnambulizing among the chimney pots. The war was for those times enormously costly. It was conducted by Pitt the First, afterwards Lord Chatham, a theatrical and expensive gentleman, who rather liked throwing the nation's money about, or, as Lecky sonorously says, "seemed to take a strange pleasure in rather exaggerating than attenuating the pecuniary sacrifices he demanded." Sixty millions * were added to the debt, which at the peace of 1763 had risen to about 140 millions. But the war was very glorious and very popular, and during the course of it we incidentally drove the French out of India and Canada, so laying the foundations of the British Empire.

By so doing, however, we also sowed the seed of its dismemberment. "Already," writes Lecky, "amid the blaze of the victories of Pitt, the strange Nemesis which so often dogs the steps of great human prosperity may be clearly descried. The destruction of the French power in America removed the one ever-pressing danger which secured the dependence of the English colonies on the mother country. The great colonial forces raised and successfully employed during the war

* Fenn on the Funds.

gave the colonies for the first time a consciousness of their strength, and furnished them with leaders for their War of Independence; while the burden of the debt due to the lavish expenditure of Pitt revived the scheme for the taxation of America which led in a few years to the dismemberment of the Empire." *

England's claim against the American colonies was a very just one. She had spilt much blood and spent much treasure in the war which eased them of the presence of France as a neighbour. She had paid them to fight for their own delivery, and they had rewarded her by driving a brisk trade with the French forces which England was fighting. She never asked them to take on their shoulders any of the burden left by the war against France, or to put one penny into her pocket; she only proposed that they should take on themselves a little of the cost of keeping an army in America to defend them against Indians and a possible French attack.† But the home Government handled its case with such marvellous stupidity and want of tact that it brought about a war which was denounced and deplored by the best opinion both of the colonies and of the mother country. It nearly doubled the English debt, which was 127 millions when it began, and 245 millions when it was over, or

* "History of England," ch. vii.

† *Ibid.* ch. xi.

rather, when its expenses had been wound up and settled.

French help enabled the Americans to beat us, and so France took its revenge for its defeat in the Seven Years' War. By so doing it plunged itself into bankruptcy, which bankruptcy was a chief cause of the French Revolution, and so of our next and costliest war.

It is generally maintained by historians that our war with revolutionary France, usually called the Napoleonic war, was forced upon us, but their arguments are by no means convincing. Lecky, who admits that he changed his mind on the subject, argues his case through so many yards of prose that he makes one suspect it to be a weak one. He says himself that "a policy of strict non-interference was probably that which would have given France the best chance of speedily throwing off the fever under which she was suffering, and if such a policy was not pursued by the other Powers it was at least in the highest degree to the advantage of England to remain as long as possible neutral in the conflict." * The other Powers, as all men know, attacked France while thus fever stricken, made her mad with fear and suspicion and rage, and produced all the massacres and horrors that stained the progress of the Revolution. Why did we give up the policy of neutrality which Lecky

* "History of England," ch. xix.

admits to have been the best, if it could be maintained? "The English case," he says, "was essentially a cumulative one, depending on many indications of French policy no one of which might perhaps alone have been decisive, but which when taken together produced an absolute certainty in the minds of the ministers that the French were determined to incorporate the Belgic provinces; that they were meditating a speedy invasion of the Dutch Republic, and that if an insurrection broke out in the Republic it would be immediately supported by French arms."* In other words, according to this authority, we dropped the policy that was best for all parties because we thought that the French were going to do something that we should not like, and so we made war to encourage them to behave pleasantly. This seems a flimsy reason for the most costly war that we ever had, and the actual course of events is rather in favour of the view that we fought France because she had cut off her King's head, and so frightened our own King out of his wits. When the French deposed their King we recalled our ambassador, and when they beheaded him we turned their ambassador out of England, and so made war unavoidable, because they did exactly what we had done a century and a half before. Thorold Rogers puts this view of the

* "History of England," ch. xx.

case in his "Industrial and Commercial History." "Our policy," he writes, "was to let France alone, just as France let England alone, when she made war on, deposed, and executed her King. It seems to me impossible to doubt that if France had been let alone, and all interference in her domestic affairs discouraged or prohibited, the fire of revolution would have speedily burnt itself out. I conclude that we owe . . . our intervention in French affairs and the twenty-two years' war to the obstinacy of George the Third." *

As evidence of contemporary opinion, it may be noted that some of the great Whig families, including the house of Russell, gave up the use of hair powder, by way of protest against this war, because a tax was laid on it which went to meet the cost of the struggle. But whether this war was forced on us or no, there can be no doubt that it was most recklessly financed. Pitt the Second, who held the helm of State through its course, made the mistake of believing that because France was bankrupt she could not keep up the fight, and so financed the early part of the war entirely out of loans, which he issued on terms which were ruinous to the credit of the country. "In the first six years of the war, he raised by loans not less than £108,500,000, and he raised them on terms so unfavourable that they added nearly

* P. 419.

£200,000,000 to the capital of the National Debt." * British three per cents., which touched 97 in 1792, fell to 47 in 1797. This war added more than 613 millions to the National Debt, and did so merely because of the reckless finance which marked its conduct. When the price of Government stock had been shattered, and it became necessary to finance the war out of revenue, Pitt at last put on his 10 per cent. Income tax, with such results that, as Mr. Gladstone showed in one of his famous Budget speeches, "Our debt need not at this moment have existed if there had been resolution enough to submit to the Income tax at an earlier period." †

In other words, if the rulers of the nation had had the courage to call on it to face the responsibilities of its acts at once, instead of waiting until their power to borrow was exhausted, posterity ought never to have been left with that burden of 600 millions.

The Crimean War has already been written off as a piece of stupidity, though the debt incurred to conduct it remains a liability of the nation. It was of this war that the late Lord Salisbury airily remarked that we had put our money on the wrong horse, thus very pleasantly reducing the efforts of our rulers in the domain of foreign policy

* Lecky, "History of England," ch. xvi.

† Quoted by the "Arbiter in Council," p. 433.

to the level of the endeavours of the impecunious to improve their fortunes by backing a winner. It was comparatively well financed and only added £30,400,000 to the National Debt.

As for the South African war, remnants of the high taxation that it brought with it are still with us, and it is very safe to assert that whatever its results may have been in other respects, it brought us, as a nation, no economic benefit. Its contribution to the Debt was about £160,000,000.

The British Debt, then, owes most of its existence to the habit of our ancestors of "stumbling among the chimney pots," going to war generally about quite irrelevant matters of Continental politics and leaving the bill unpaid. The development of a market in securities at the end of the eighteenth century enabled our rulers to sell the nation's credit to an extent which at first appeared to be unlimited, and so tempted them irresistibly to use this attractive method of providing the sinews of war instead of taxing the nation. The system worked pleasantly enough, lent itself kindly to the desirable object of distracting public attention from the fearful cost that war brings with it, and sometimes helped statesmen to keep their Parliamentary supporters in a good humour, with pickings out of loans. In 1781 twelve millions were borrowed on such terms that the price at once rose from 9 to 11 per cent. above par, and

"following the evil precedent set by the ministry of Bute in 1763 a great part of the loan was distributed among the creatures of the ministry, who were thus gratified by an enormous though veiled bribe."* Summing up the tale of the war-created debt, we can express it thus in approximate figures :—

	Millions
William's War against Louis	19
Spanish Succession War	17
War of Jenkins' alleged Ear	30
Seven Years' War	60
American War	118
Napoleonic Wars	613
Crimean War	30
South African War	160
	1047

Such is the bill, reduced by slow redemptions of debt during intervals of peace, for which we British citizens are liable, largely owing to the habit of our rulers of sleepwalking, and "stumbling among the chimney pots." The wars which were the consequence are a picturesque and very glorious addition to our history, and have given us some of the noblest figures that adorn its roll and enrich our literature. Captain Shandy, Corporal Trim, Colonel Esmond, and a host of others are on the credit side of the account, and it may be that the memory of our warlike deeds has its good effect to

* Lecky, "History of England," ch. xiv. vol. v.

this day on the national character. Nevertheless, when we look at the matter from a purely economic point of view, and when we think of what the sums added to our debt by war might have done in quickening England's industry, tilling her soil, and making her sons and daughters clever and wise and strong and happy, perhaps we shall be a little inclined to hope that in future our rulers will give up the habit of sleepwalking, and try to stay awake while they are in office.

Owing to the strong individualism that has ruled English policy and the consequent opposition to the undertaking of any enterprise by the State which could be left to joint stock or private energy, our Government has little or nothing to show in the shape of profit-earning assets. The Government has been somehow allowed to undertake the task of distributing letters and parcels and does so in a manner that compares well, on the whole, with the efforts of private enterprise as exemplified by the railway companies. One loses letters less often than luggage, and the post is much more punctual than the train service even on the best of our great lines. But the task of the Post Office is evidently a simpler one than that of the railways, and the lamentable mismanagement of the finances of the Post Office Savings Bank shows that many lessons have to be learnt before the extension of Government enterprise can be welcomed as a

means of avoiding the waste and friction that come from the competitive conduct of industry and commerce, and the danger of monopoly that arises when competitors cease from competing and form themselves into a ring.

In other countries where the individualist spirit is less vigorous, the Governments have kept in their own hands industries which yield them a revenue. Most of the Continental nations own their own railways, and in times of prosperity the kingdom of Prussia earns from them and from its well-managed State forests enough to pay the interest on the whole of its debt. A tobacco monopoly is a source of revenue to some Governments, and of woe to those who smoke the consequent cigars, and the Russian Treasury makes a profit by selling spirits. Most of our colonies have preferred to keep their railway systems in the hands of the Government rather than allow it to be worked for the profit of shareholders, and though Canada has largely followed the example of its individualistic neighbours in the United States, its Government has done much in the past to encourage railway building with subsidies and land grants, and has lately gone more or less into partnership with the Grand Trunk Company in the making of a new line to the Pacific.

There is no need to discuss here the comparative merits of State and private enterprise. Both have

their advantages and drawbacks. The good management of the best English railways, always brought forward by the champions of the competitive system, is an argument that can be answered by a journey on the worst, or even on the branch lines of the best; and the State with its higher credit is able to spread facilities for travel and traffic for the benefit of the whole community and its trade. The only point at which this question of collective enterprise touches the present inquiry lies in the fact that those Governments which have made use of their credit for the working of reproductive enterprise are so far in a better financial position than those which have nothing to show against their debts but records of war and accumulated yearly deficits.

As an example, let us look at the case of Bulgaria, as exemplified by the figures of the prospectus referred to in a previous chapter, by which it offered a loan early in 1910. Here is an extract from this document—

The Royal Bulgarian Government has at present the following Debt :—

Loans.			Outstanding on Jan 1, 1910.
		£	£
1892	6 per cent.	4,998,500	3,614 480
1902	5 „	4,240,000	4,091,600
1904	5 „	3,999,200	3,908,000
1907	4½ „	5,800,000	5,759,800
			£17,373,880

The Royal Bulgarian Government owns the following property:—

		£
About 2,041 km. of Railways, constructed or under construction, including Rolling Stock ...	valued at	13,439,079
Land, Forests, Buildings, &c. ...	" "	29,628,071
Capital and Reserve of the National Bank of Bulgaria, and other Capital	" "	877,602
Harbours and River-Ports ...	costing	993,312
Canals, Telegraph and Telephone Lines, Roads, Bridges, &c. ...	"	5,660,389
		£50,598,453

The value or cost price of this little Government's assets are nearly three times the amount of its debt. It is a remarkable exhibition, which would make Bulgarian bonds a first-rate security, were it not for political and other considerations which complicate the problem.

Debts of municipalities are free from the burden left by war, and are, or ought to be, represented in every case by expenditure which has been laid out for the benefit of the community. They do not necessarily earn a revenue, but they are capital which has been sunk in furthering public health by means of parks and open spaces, street widening, baths and wash-houses, or in improving public intelligence by libraries, galleries, and other aids to thought, learning, and the perception of beauty. Owing to the limited area from which they draw

their income, they inevitably enjoy a lower credit than Government stocks, and owing to their smaller amounts they are less easily marketable. Nevertheless, the stocks or bonds of a well-ordered municipality are a very fine security, less likely to vary in price with the risks of war and politics than a Government stock, and, in England at least, generally supported by strict and definite arrangements for redemption at a date.

It is likely that they would be more fashionable and more highly priced than they are, were it not for a common suspicion that municipal expenditure is often spendthrift and unwise, carried out by hot-headed zealots who think that any scheme which will be of benefit ought therefore to be put in hand, without giving enough thought to the cost and the effect of its costliness on the purses and tempers of the ratepayers.

Probably there is often a good deal of ground for this suspicion, and it may easily happen, owing to the apathy and lack of public spirit with which many communities regard their municipal business, that those who control municipal finance give too little thought to the interests of those who have to find the money, and so raise rates to a point which drives industry and enterprise out of the town. Like everything else, municipal finance depends for its success and cleanness on the men who handle it, and their probity, public spirit and

common sense. When these are lacking, spendthrift expenditure on ill-considered schemes is common enough, with a discontented and overtaxed community, slow of growth and low in credit, the unavoidable outcome.

Another cause of the rather forbidding countenance which the City turns towards municipal loans, is the eagerness with which Corporations have lately claimed the right to manage certain forms of revenue-earning enterprise, with the help of capital raised on the security of the rates. This tendency is disliked, not only owing to the individualist prejudice which is strong and in many ways healthy, but also because the company-promoting and stock-dealing classes think that their province is invaded when tramways, waterworks, gas and electric lighting businesses are taken over or started by municipalities. Joint stock enterprise thus loses a chance of floating companies and dealing in their securities, which are much livelier and more interesting and profitable, to those who know how to handle them, than municipal stocks with their sober serenity and comparatively stable credit.

From this prejudice arises the somewhat acrid criticism with which municipal enterprise, when it tries to earn industrial profits, is often assailed. Such criticism does it good, and it wants all that it can get. Municipal enterprise has certain idealistic

tendencies which are admirable in their right place and up to the right point, but may lead to mischief unless carefully watched. For instance, it was a wholly noble instinct that led the London County Council to use a more expensive system of underground tramway traction rather than earn a larger profit from its trams by the use of the ugly overhead wires. It is all to the good that the community should sometimes be reminded that pounds, shillings and pence are not the only things in life, and that appreciation of Beauty, in its widest sense, is the essential basis of real civilization. But it may be doubted whether this sacrifice made on the altar of Beauty at the expense of the ratepayers was altogether wise, in view of the heavy burden which the growth of local and Imperial taxation continually heaps on the shoulders of Londoners.

When criticism of municipal enterprise calls for clear and candid accounts, it is making a claim which it is to the highest interest of all parties to grant. There should be no obscurity about the manner in which depreciation is being treated, no possibility of expenditure on street widening, which ought to be charged against the tramway revenue, being dealt with under other headings, with the result that the tramways are made to look more profitable than they are. It is easy to retort that in the matter of finance the tramways

that are managed by joint stock enterprise fall lamentably short, and that their results achieved are by no means in favour of the view that a company can work a business better than a corporation. This may be true, but is not to the point at present; for the unfortunate shareholders in the British Electric Traction and the London United Tramways companies are shareholders by their own choice. No one forced them to embark their money in these ill-starred undertakings. But the ratepayers, on whose account the London County Council works its tramways, are not nearly to the same extent responsible for finding themselves engaged in the enterprise. Collectively they are responsible, but many individuals among them dislike the whole system, and it is therefore a matter of great importance that they should be given the fullest opportunity, by means of clear and plain accounts, drawn up so that he who runs may read, of judging the progress of the enterprise.

The need for prudent management and clear accounts on the part of municipalities is all the greater if—as seems rather likely—the system of conducting enterprises of this kind, which involve monopoly and a public convenience, by the community, will grow until it has ousted joint stock enterprise. At present, both systems may be said to be on their trial. Joint stock enterprise has achieved magnificent results, tempered by

lamentable failures. Where competition was possible it has competed to an extent that gave its customers facilities which were often absurd and unnecessary, and left its shareholders with diminutive and dwindling dividends. Where competition was out of the question, the service was apt to be inadequate, unpunctual and unenterprising.

Competition among the great railways of England has produced results which have raised a storm of complaint on the part of shareholders, who have organized themselves into a committee to protect their interests, and yet were very far from satisfying the traders and travellers who used them. The system of building lines according to the haphazard fancy of adventurers who think that a service from here to there may pay, and work with no respect for the question of organizing a railway system as a completed and homogeneous whole, can only end in chaos or a combination. England has experienced the chaos and is now struggling, thanks to a new light that has dawned on railway Boards, into combination. It is clear that when railways take to combining, they must needs submit to much closer supervision on behalf of the community, which has granted them the powers which they propose to weld into a joint monopoly. Already the nationalization of the railways has been whispered of, even by those who are strongly opposed to collective enterprise

in principle, as the only means for solving the problems of the position. London's traffic is still at the stage of chaos, which is here complicated by the mixture of the two systems, and the consequent competition of County Council trams with the suburban trains of companies which are big ratepayers. Apart from this added knot in the tangle, the position is difficult and unsound. The opportunities given by a host of tubes, underground railways, and motor omnibus companies, provide the public with wonderful facility for travelling in some parts of the town, and remarkable inability in others, and here again leave the shareholders hungry and dissatisfied. The chaos is so complete and the difficulty is so great of arriving at any agreement among the competitors which shall save them from cutting one another's throats, that they can only cry out helplessly for the setting up of a Traffic Board, to oversee them in the interests of the community and of themselves.

Individualist bias, the power of the joint stock interests and the almost complete lack of public spirit among the citizens of an overgrown and unwieldy community left London dependent for its lighting and water on the services of companies. The rule of the water companies produced results so unsatisfactory that even London was roused to buy them out and consolidate the service under collective management, and since then the dearness

of the water supply has been a trusty weapon in the hands of the enemies of collective enterprise. In the matter of lighting London buys gas from two companies, of which one, which serves the richer and apparently more profitable part of the town, habitually charges about *6d.* per thousand feet more than its rival in the south, an anomaly for which a satisfactory explanation is still to seek. Its electric lighting, parcelled out among companies, is trying to struggle out of chaos by combination, but in this case the companies have lives which are limited and the community will in due course be able to take the services over or lease them. Dwellers in London thus have the faults and drawbacks of the two systems—joint stock and municipal—clearly before them. On the one hand there is the costliness, and occasional excursions into fantastic idealism, of the municipal worker. On the other, a journey in a suburban train, especially to those who are not inured by daily habit to its hardships, is a cure for many illusions concerning the beauties of joint stock management.

Whether good or bad, municipal enterprise is here to stay, and both parties in the London County Council and other great municipalities are eager, though in a varying degree, to extend it. Whether we like it or not, all that we can do is to try to improve its management and finance. Here it is, and it will doubtless in future be a fruitful

cause of the creation of municipal securities. Whatever mistakes it may make, it will at least be less unprofitable than most of the wars which have left us with £700,000,000 odd of Government debt.

CHAPTER VIII

THE STOCK EXCHANGE

HARD by the Bank of England, from which it is divided by Bartholomew Lane, is a three-cornered block of buildings, the kernel of which is the Stock Exchange. It is a source of bewilderment to visitors to the City that they never can see even the outside of the home of the market in securities. Two sides of the triangle in which it dwells, and most of the third, are made up, as viewed from outside, of the offices of banks, insurance companies, and other firms and businesses; and the fact that the Stock Exchange thus lurks in the background, and shows no front to the light of day, helps to deepen the mystery that veils its working and dealing from the eyes of the public. Entrance to it is gained by several courts and alleys that pierce the outer shell of buildings, and by one or two doors which lead more or less straight into it from the street, but always through a passage or up a flight of stairs.

Within, it is a vast hall of irregular shape,

evidently having grown along the line of least resistance as it was added to piecemeal, and bulged out as it best could to make room for the waxing numbers of its denizens. To one entering the House, as it is called, for the first time, it gives the impression of an unspeakable Babel of sound and a blurred mass of men, most of them, apparently, very earnestly engaged in doing nothing. As the untrained ear begins slowly to unravel the tangle of noises, it discovers that the loudest and most penetrating of them are produced by uniformed officials called "waiters," sitting by the various doors, who are shouting the names of firms that are wanted by visitors or messengers, or for which telegrams or other missives have arrived; but the background of sound is provided by the members themselves, who talk incessantly as they stand about in groups; while from time to time a wave of excitement in one corner or another of the House marks its progress by an outburst of apparently inarticulate yelling.

The indifference with which these bouts of shouting in one part are received in the rest is accounted for as the eye gradually notes that the crowd which covers the floor is roughly divided into groups, all of which are more or less stationary, though there is a constant stream of men walking to and from them, and between them. These groups are the markets in the different kinds of

securities. One group, which we see first if we enter by the Capel Court door, deals in Consols and other Home Government stocks, Colonial stocks, and British Corporation stocks. Another, again roughly split into three sections, in Home Railway stocks. These markets, as we make our survey, are evidently idle. In the Consols market the chartered jester of the House is mimicking the Parliamentary manner of a broker, prominent as a politician, who is trying to look as if he enjoyed the entertainment. A knot of the Home Railway dealers is canvassing the probable effect of the French floods on the traffic of the lines which carry passengers to Paris, but most of them have abandoned all interest in business questions, and are making a book on a member who has backed himself to run to the top of the Monument and back in twenty minutes. To the left of the Home Railway market is the big gathering of dealers who form the American market, and as the time of day is soon after three in the afternoon, we can watch this market wake from sleepiness into keen excitement as the opening prices arrive from New York, where it is now ten o'clock in the morning. A quarter of an hour ago not a bargain was being booked, for this morning's cables had shown that Wall Street, the home of the New York Stock market, was in one of its uncertain and capricious moods, and every one was waiting to see in what

temper it would open. Dealers had given themselves up to play and banter, and had discovered with unholy joy one of their number nodding drowsily after his luncheon, on one of the few benches that break the clear space of floor. It had been the work of a few moments to pin a placard on his slowly heaving waistcoat, with the legend, "I am not drunk but born tired," and an admiring ring of scoffers was gloating over the masterpiece, and waiting for the victim to awake, when suddenly New York begins to "come in," in the shape of cable messages handed to the dealers who have correspondents in New York, and carry on what is called an arbitrage business with them.* At once the market ceases to be a group of idlers, and knits itself into a close-packed group of eager men of business, with every nerve taut and alert. A few silent bargains are done in the centre of the market, and then the arbitrage men break into a chorus of bidding, and the whole pack takes it up in full cry. Brokers and their telegraphing clerks make haste to send prices off to clients who might be tempted to deal by the news, and the market settles down to rollicking strength, probably to be checked in half an hour by a fresh spell of cold shivers in New York.

* That is, buy in New York and sell in London, or contrariwise, whenever the differences in prices in the two centres give a margin of profit.

Beyond, where the House bulges into a roughly circular shape, there are similar groups dealing in foreign bonds, foreign railways, mining shares, industrial shares, rubber shares, bank shares, and so on all up and down the gamut.

A market on the Stock Exchange is thus a group of men standing in a certain place in the House, and ready to deal in a certain class of securities, in which it specializes. These men are the dealers, or jobbers as they are more commonly called. They deal with one another, and with the brokers, and the brokers, who deal for and on behalf of the outside public, go to them to carry out its orders, as we shall see more clearly when we come to trace the history of a Stock Exchange bargain in detail. A mistake, which is commoner than one would expect, makes folk imagine that the Stock Exchange is something like a vast warehouse, where securities are taken down from shelves, and sold across counters at a price fixed in a catalogue, which is called the Official List. This illusion makes those who cherish it miss the actualities of business altogether. The Stock Exchange is a mass of men, and their human and inevitably fallible sentiments and opinions are a very important factor in the influences which combine to settle the prices of securities. Any mass of men is likely to become at any moment an excited mob, and may sometimes degenerate into something like a herd

of stampeding cattle. Any one who has ever stood in a crowd whose feelings have been wrought upon by some striking news, or the eloquence of an orator, or the patter of a sophist, knows how his neighbour's excitement tingles through into himself, and back again, and so on in waves through all the gathering, until it is all a mass of quivering nerves, and can be played on to any tune, or jarred into any discord. The Stock Exchange stands in a crowd all day, and is consequently excitable, and given to moods and exaggerations. Its temper is like the maiden in the nursery rhyme, of whom it was written—

> "There was a little girl, and she had a little curl
> Right in the middle of her forehead.
> And when she was good, she was very, very good;
> But when she was bad, she was horrid."

So the Stock Exchange is apt to see everything either through roseate spectacles or through the bilious eyes of a dyspeptic sufferer. Its spirits are "now," as Falstaff puts it of Diana's foresters, "in as low an ebb as the foot of the ladder; and by-and-by, in as high a flow as the ridge of the gallows."

How the Stock Exchange came to be there is a story which has been told at length, by John Francis * and Charles Duguid † among others.

* "History of the Stock Exchange."

† "The Story of the Stock Exchange."

For our present purpose it is enough to record that trafficking in stocks and shares first became a popular business and diversion at the time of William and Mary, though it must have existed on a small scale very much earlier. We have seen in Chapter I. that joint stock companies were formed in the days of Elizabeth, and Mr. Fletcher tells us in his History, in enumerating the reforms of Archbishop Laud, who enraged our Puritanical forefathers with his High Church notions in the reign of Charles the First, that "St. Paul's Cathedral was no longer to be used as the Royal Exchange *plus* the Stock Exchange." * But the fact that the market and the dealers in securities first came into prominence at the time of the Revolution, and that stockjobbing, loans to Government and the foundation of the Bank of England were part of a machinery of which skilful use was made by William the Third's Government, gave a Whiggish flavour to the business and earned for it the dislike and contempt of the country gentlemen and Tories.

Traces of this dislike are to be found here and there throughout the literature of the eighteenth century. Dr. Johnson, in whose hands even dictionary-making became a means for sonorously smiting those with whom he did not agree, defined a stockjobber as a "low wretch who gets money

* "Introductory History of England," vol. ii.

by buying and selling shares in the funds," and quotes as an example a few lines from Swift—

"The stockjobber then from Change Alley goes down
And tips you the freemen a wink;
Let me have but your vote for to serve for the town,
And here is a guinea to drink."

The reference is evidently to the power of City-made money in politics, which in the eighteenth century began to become prominent. The writer of certain pamphlets signed "Veteran," which appeared in 1772, had reason to attack a prominent politician called Chamier, against whom nothing could be alleged except that in his youth he had had some concern with Stock Exchange business. This was quite enough for his assailant, who in letter after letter "describes him with wearisome iteration as 'Tony Shammy,' a little gambling broker, 'a little Three per Cent. Reduced,' 'a mere scrip of a Secretary,' with 'the activity of a broker and the politeness of a hairdresser,' 'a little Frenchified broker from Change Alley,'" * and so on. Throughout the eighteenth century business in stocks and shares was chiefly carried on in the coffee houses in and around Change Alley, and it was in 1802 that the Stock Exchange built itself its House and established itself as a separate body with its own rights and rules.

A very unflattering picture of the stockbroker

* Lecky, "History of England," ch. x.

of this period is given by Captain Marryat. Everybody remembers how Peter Simple on his way through London to join his ship lodged for a few nights with his father's stockbroker, Mr. Handycock, who lived at 14 Clement's Lane. Mr. Handycock wore "blue cotton-net pantaloons and Hessian boots with a black coat and waistcoat." Because markets had gone against him, he swore at his wife and at Peter, ate all the fish and most of the veal (Mrs Handycock called it weal), and otherwise behaved like a low ruffian. Next day, when prices had moved to suit his taste, "I never," says Peter, "saw a man more polite than Mr Handycock. He joked with his wife, asked me to drink wine with him two or three times, talked about my grandfather;* and, in short, we had a very pleasant evening."

Dickens strikes a kindlier note in the great scene describing how Mr. Pell took Tony Weller and Sam and three coachmen who attended informally as umpires, "selected by Mr. Weller probably with a view to their width and consequent wisdom," to sell out and transfer the stock left to Tony by the lady who had taught him his uncompromising views about widows. When the party arrived at the office of Wilkins Flasher, Esq., the stockbroker chosen by Mr. Pell, he was found in conversation with a brother of his craft, "a very

* Peter's grandfather was a Peer.

smart young gentleman who wore his hat on his right whisker, and was lounging over the desk killing flies with a ruler. Wilkins Flasher, Esq., was balancing himself on two legs of an office stool, spearing a wafer box with a penknife, which he dropped every now and then, with great dexterity, into the very centre of a small red wafer that was stuck outside. Both gentlemen had very open waistcoats and very rolling collars, and very small boots, and very big rings, and very little watches, and very large guard chains, and symmetrical inexpressibles and scented pocket-handkerchiefs." It will be remembered that the conversation between the pair turned on one Boffer, who had just been "expelled the house," showing that this term for the Stock Exchange is of old standing. First they bet that Boffer would kill himself within ten days, and then that their respective butlers would outbid one another at the sale of the expelled member's sixty-four port. Then Mr. Simmery, "having killed all the flies and taken all the bets, strolled away to the Stock Exchange to see what was going forward," and Mr. Wilkins Flasher carried his clients off to the Bank.

The modern member of the House is, as a rule, a much less flamboyant personage than the type drawn by Dickens in his genial satire, and it would be difficult to find among the members of to-day any reproduction of the ill-mannered churl who bullied

Peter Simple. Living and working as they do in the midst of a crowd which loves to while away its idle moments in banter and practical joking, they are generally careful to avoid anything like peculiarity in dress or demeanour, since it would at once mark them as a butt for the humour of their fellows. Stock Exchange humour is a very characteristic growth with a certain sardonic bite in it. On one occasion a foreign municipality was arranging to raise a loan when an untimely outbreak of cholera appeared in its precincts. Somebody remarking that cholera would be bad for the town's revenue and so for the prospects of the loan, was at once reassured by the broker in charge of the issue. "You see," he said, "the municipality owns the cemetery, and so what it loses on the swings it will gain on the roundabouts."

Besides the cultivation of this precious gift of rather bitter humour, the Stock Exchange has a great store of talents and versatilities. Its prowess in the various branches of sport is well known. It periodically produces a picture show which is well above the average of amateur effort, and many of its members have a happy gift of caricature. One of them, whose effort has been preserved and reproduced, was inspired by the regulations drawn up for the House point-to-point races. They directed that "All horses must be ridden in hunting costume," and the artist at once

drew a sketch depicting a horseman clad simply in a sash bestriding a steed decked out with a complete outfit from top hat to top boots. The Stock Exchange choir and orchestra have a high reputation in concert rooms, but some of their happiest musical effects are produced spontaneously and without rehearsal, when on idle days the House serenades some member who is a churchwarden, or is suspected of ritualistic leanings, with a sort of Gregorian chant; the dirge-like music, suddenly taken up by a large number of male voices, gives a most effective impression of mediæval solemnity and "grey Gothic twilight"

The Whiggish associations of the early days of stockdealing have long been left behind. There is still a small leaven of Liberalism in the Stock Exchange, but the overwhelming majority of its members are Tories with an ingrained and robustious Toryism, of the bluff, boyish, breezy type, always ready to cheer and demonstrate and sing "God Save the King" on the shortest notice. Its patriotism is noisy and demonstrative, but at the same time very practical and ready when there comes any demand for subscriptions for a national purpose, or "when the guns begin to shoot," and men are wanted for the front, as was shown at the time of the South African War. And it is perhaps relevant to add that one of the outstanding features of the

collective character of the House is its openhanded generosity, and quickness to respond to all kinds of charitable appeals. Its standard of honour and of honesty is singularly high. Its business could not be done without an amount of mutual confidence between members, and an implicit reliance on the spoken word, or even a gesture or a nod, as the beginning and end of bargains involving perhaps millions of pounds, which the House itself takes as a matter of course, but a thoughtful new-comer always marks with some astonishment. It holds and handles securities on behalf of the public, the value of which runs into many millions, and some of its more impecunious members often find themselves in uncomfortable corners. Yet it is the rarest occurrence for a stockbroker to abuse the trust of his clients who leave securities in his charge.

The constitution of the House and the conditions of membership have not been in its favour in one very important respect. The Stock Exchange is to all intents and purposes a proprietary club, the proprietors of which are necessarily members, but the members of which were until 1904 not necessarily proprietors. It is owned by a joint stock company, the shares in which can only be held by members, but were actually held by a comparatively small number of them. A reform which then provided that every new member

should possess himself of at least one share is a comparatively modern innovation. Hence it followed that the interest of the shareholders was not necessarily that of the members as a whole, and was in fact rather opposed to it. Since the revenue of the company which owns the House is chiefly got from entrance fees and subscriptions, it was to the advantage of the shareholders that there should be as many members as possible, and the door has thus been opened wide to any new-comer who could pay his entrance fee, and find two or, in some cases, three members to go surety for him to the extent of £500 each for a period of three years. A question was regularly put to his sureties whether they would be prepared to take his cheque for £2000 in the ordinary course of business, but the affirmative answer by no means implied that the applicant for membership was possessed of £2000 of his own, but only that he would not draw a cheque for that amount unless there were funds at his bank to meet it. Now, thanks to recent reforms, a new member must buy a share, and in most cases a nomination, and, as a rule, has to find three sureties; but the amount of capital required from him is still quite trivial, when compared with the £14,000 or so that a new member of the New York

NOTE.—For important changes in the admission of new members, see Supplementary Chapter on p. 356

Stock Exchange has to pay for his "seat," or the sums amounting in all to more than £90,000 that a Parisian capitalist * has to put down before he can become an *agent de change.* It is practically impossible for a member of the Paris Bourse to fail, and if he did his brother members would be liable for his debts. In New York, if a member fails he has got his seat to sell for the benefit of his creditors. In both these centres the anomalies are absent which make it the interest of the owners of the London Stock Exchange to have as many members as possible, and consequently have made them neglect the necessity for insisting on a high level of financial strength. In Paris, the failure of an *agent de change* is an almost unheard of event. In New York a failure is comparatively rare. In London it is much too frequent.

Something has been done to amend this weakness, but the beginnings have been necessarily timid and halting, and it seems likely that no serious reform will be carried through until the House asserts itself as a corporate whole, buys out its present proprietors, and manages itself in its own interests and those of the public. It is clearly to the public advantage that the men who handle its securities should be themselves possessed of reasonable financial resources, and

* He is generally the active head of a group of sleeping partners who help him to provide the capital.

that the system should be modified by which it is possible for a bright youth with a few hundreds in his pocket and a few friends in the House who will stand surety for him for auld lang syne, to start in business on the Stock Exchange. Members of this class are very likely to be in a great hurry to increase their resources and to take short cuts, by way of speculation or bad business, which lead them into uncomfortable corners. Then we begin to hear of a weak professional bull account, and markets quivering under forced sales, and an element of instability and weakness is introduced by the very body of men which is paid a handsome income, year in and year out, by the public to provide it with a mart in which it can buy and sell its stocks and shares. This duty the House does not adequately perform when by its own lack of financial stability it adds to the quaking of the quicksand of quotations.

We thus must add comparative impecuniosity (when judged by the standard of the other great Stock Exchanges) to the items in the character of the typical member of the House. His character is very important not only because he is an interesting and highly specialized part of the modern financial machine, but because, as we shall see in a later chapter, the movements of securities are largely a psychological question, that is to say, a question of what is thought and felt by a certain

number of men. What is thought and felt by members of the House is a very large item in the problem, because it is chiefly from them that the newspapers and the public take their thoughts and feelings on the subject; so that it is very relevant to the purpose of those who want to know all about stocks and shares, to form a clear idea of the Stock Exchange man, with his virtues and his shortcomings. Summing him up, with all the caution that is required in a collective character study of some five thousand human souls, we may say that he is humorous, open-handed, highly honourable, Tory from head to heel, with wide interests, and a remarkably keen eye to business. He does not trouble himself much about taking long views. "That won't happen this account" is a formula with which he often dismisses matters which are not of immediate moment, but he is astonishingly quick and alert in seizing the meaning of the passing mood and scenting the possibilities of to-morrow. From the nature of his business, which makes him spend much (in the case of a dealer, all) of his time standing about in a crowd, he is constantly exposed to excitement and the electric thrills which sway mobs into ebullitions of over-wrought feeling. By the comparative lightness of his purse he is tempted to make haste to make money, either by speculation on his own account, or by not being

careful enough concerning the class of business that he undertakes, whether for the public if a broker, or for other members if a dealer. He is a very pleasant, good-natured, clean-handed person, with much of the cheery heartiness of the sailor, but for thought-out views on the subject matter of his business, we have to look to the exceptions among the members, rather than to the type.

The presence of a large foreign leaven in the House has not had much effect on the collective characteristics of the members, the English type being strongly predominant. These adroit and quick-witted strangers within the gates have made the cut-throat stress of competition rather keener, and have probably helped the House to gain the adaptability and readiness for new ideas in business which is one of its healthiest qualities. But the adaptability which the foreign element has taught, it has itself practised. It has readily recognized the benefits of the straightness and respect for the spoken word as the basis of a bargain which an Englishman may be proud to claim as the most English feature of the Stock Exchange, and it sometimes carries its desire to be quite English to the point of absurdity, by trying to veil its alien origin by adopting ultra British names. "Another half-commissioned officer in the 64th Highlanders," said a grim old member of the Committee, when an evidently Semitic applicant

for membership presented himself with a name that had been distinguished in the charge of the clansmen at Prestonpans. This gibe riddled in one sentence the readiness of a certain class of foreign immigrant to deal for half the usual commissions (a practice that has now been forbidden), their introduction of the sixty-fourth of a pound as a fraction in Stock Exchange business, whereas the thirty-second had hitherto been the smallest division known, and their passion for disguising their origin. English members sometimes growl at the manner in which their brethren of alien extraction cut the terms on which business is done, but it is probable that the Stock Exchange has learnt a great deal from foreign influence, and has been saved by it from the "take it or leave it" attitude which is one of the vices of our national character, except when we are spurred by the example of a keener and more hardworking race.

Members of the Stock Exchange are definitely divided into two classes, brokers and dealers, the latter being more commonly called jobbers. This division is peculiar to London, for though in other centres the dealer is more or less reproduced, he is not definitely and officially distinguished into a separate class. The essential basis of the division is the fact that the broker buys and sells stocks and shares on behalf of his clients in the outside world, while the jobbers deal only with the brokers

or with one another, and provide the market in which the brokers carry out their orders. The jobbers are the men whom we saw standing about in groups on the floor of the House, and these groups were the markets in the various kinds of securities. The brokers are either dealing in the various markets or are in their offices, listening and talking to clients, or, if their business is chiefly from the country and so comes mainly by letter or by wire, they are to be found in the House within earshot of one of the waiters who shout the names of members who are called for, or for whom telegrams arrive. All firms of brokers have a point in the House at which they can be called, and most of them always have one or more representatives there, to keep a finger on the pulse of markets and an ear open for the gossip, rumours, reports, facts, fancies, and political information, which form the ever-changing ingredients of the bubbling cauldron of Stock Exchange sentiment. The brokers who have business to do and are passing from one market to another to do it, are the moving element in the picture as we first looked at it.

Stockbrokers are a class of the community which does more, and more important, work for nothing than almost any other, and is often rewarded with ingratitude, sometimes with contumely. The real business of the stockbroker is to receive an order

to buy or sell, carry it out and charge his commission; but by a natural development his real business has become a minor part of the work that he does. His clients, seeing that he is always in touch with market conditions and constantly engaged in testing and estimating the comparative merits of securities, have taken to consulting him as to what they should buy or sell, and often to expecting a quite unreasonable amount of knowledge not only concerning the present position and virtues of any given stock, but about its future earning power and the prospect of its improving in value. All this part of his work, which is evidently the most tiresome and responsible and worrying, the broker does for nothing. He only charges a commission when he makes an actual purchase or sale, and the commission that he then charges leaves him a sufficiently slender net profit, by the time that he has paid expenses. His clerks have to be numerous owing to the large amount of clerical work involved by transfers of stock and correspondence with clients, which the latter expect to be explicit and voluminous; and his office expenses are necessarily big, because the clients who come to see him expect to be received in roomy and well-ordered premises. Some clients will come and talk for hours, sometimes about quite irrelevant matters, sometimes about all the securities that they have ever held or

heard of, and then go away having decided, perhaps on advice given by the broker quite contrary to his own interest, that their investments are all satisfactory as they stand and that there is no need to change them, or having requested the broker to make exhaustive inquiries and write sheets of correspondence on certain stocks, which inquiries and correspondence may be equally unproductive of business and commissions. For interviews, inquiries, and correspondence a lawyer would charge handsomely, and quite rightly. The stockbroker charges nothing.

When clients finally make their minds up to give their broker an order, perhaps involving a commission of £1 5*s*., after hours of talk and plenty of letters, they often seem to consider that they have the right thereby to expect that anything that they buy should never go down in price or disappoint any of the calculations on which its purchase has been based, and, if it does, that the stockbroker has failed in his duty. Of course it is only among the ignorant and unbusinesslike class of clients that these unreasonable views are rife, but unfortunately they are far too common. It does not seem to occur to them that if any one were really gifted with this extraordinary and invincible knowledge, not only of the past and present, but also of the future of securities, he would not condescend to do other people's business and be

rewarded by grudgingly paid commissions and lavishly bestowed ingratitude, but would make more practical use of his information by speedily amassing a fortune on his own account. A certain class of client is quite ready to write, or attend in person, and complain to his stockbroker for some misfortune for which no human foresight could have been expected to allow, which has diminished the earning power of a security that may have been bought twenty years ago. Most brokers of course become used to this sort of client and take him in their stride as an inevitable puddle in the day's journey of stockbroking existence. But to all he is more or less a terror. A broker, very pleasantly gifted with the sardonic humour that flourishes in Capel Court, was discussing with a doctor the comparative merits of their professions, and happily observed, "You doctors are on velvet, because you bury your blunders. Mine don't go to Kensal Green, but into clients' safes, and they're always liable to come out and hit me."

The most fortunate stockbrokers are those who are not brought into contact with the ignorant and exacting client who has to have everything explained at least three times, wants perfect security, 6 per cent. on his money, and a certainty of capital appreciation, and then feels hurt and aggrieved if anything goes awry. Those at the top of the tree, who can make fat commissions by carrying through

large operations for big clients who know much more about what they are doing than the broker can tell them; or those who have a snug connection with banks who hand them every morning a nice list of orders which they have collected from their customers, or with country stockbrokers who get through all the personal worry and discussion somewhere in the distant provinces and send the resulting orders all shipshape and ready to be carried out—these lead a life of comparative ease and comfort. But their number is necessarily limited, and nearly all brokers know what it is to suffer from inconsiderate clients who waste their time and expect impossibilities. The best of them take a keen and scientific interest in their work and will hunt as eagerly for a good security for a client as a mediæval knight for a dragon or a damsel in an enchanted forest; but stockbrokers whose connection lies chiefly among small and amateurish investors often do an astonishing amount of ill-requited work. Moreover, if they have clients who speculate—and the majority of brokers have not enough purely investment business to enable them to live on it—they are faced with the added difficulty that the said clients always take their profits and do not always meet their losses; and a broker who has entered into engagements on their behalf with the dealers has to meet their losses for them or declare himself a defaulter.

The desire to keep a client and do business is a great temptation to him to allow those whose resources are slender to speculate, through him, more heavily than is prudent. If he is too punctilious concerning security, or is unwilling to let his clients have large lines of stock open, he runs the risk of narrowing his connection, and, human nature being human, he is often apt to take the even greater risk of hoping for the best and of entering into commitments, on behalf of impecunious folk, which he would not dream of undertaking himself. Then comes some unforeseen shock to markets, such as a war scare or a sudden pressure in the money market, or a question concerning the credit of some important institution; prices of the most carefully selected securities shrivel like a blighted leaf, and the profit which the client expected to garner is turned into a big "difference," for him to pay, which he does not find it convenient to produce. Not long ago when fashionable gentlemen in the West End had been unusually airy in the extent of their speculations and the readiness with which they left their brokers to pay their differences for them, the Stock Exchange, grimly humorous as usual concerning its own misfortunes, defined a West End client as a "distinction without a difference."

Finally, having been worried into thread-paper by investing clients who require impossibilities

and speculating clients who leave him to meet their losses, the broker is liable to be accused of highway robbery by some ignorant soul who has been deluded by a bucketshop advertisement into a belief that there are some philanthropists who will charge no commissions, and like to do business for nothing, presumably for the benefit of their moral health. Surely, after all the cynicism that has been poured over us since the days of Diogenes, the public might be aware that people who write, or advertise, and propose to buy or sell securities for them and charge no commission, are going to make a profit of some sort out of them, or why in the name of common sense should they go to the expense of writing or advertising?

This lesson has still to be learnt, and stockbrokers are often galled by having their business filched from them by these unfair means. Sometimes, however, they get a little sweet revenge. A stockbroker lately received a letter informing him that the writer, a clergyman, had bought certain shares at 45*s.* which had been offered to him at that price by a circularizing outside firm. "I should have preferred to buy through you," the letter suavely continued, "but Messrs. Blank and Hiatus intimated that they would charge no commission, and of course I could not expect you to do that," thus with malicious politeness insinuating the enormous gulf that was fixed between Blank and Hiatus on

the one hand and the sordid commission-hunting stockbroker on the other. Providence was this time on the side of justice, and the stockbroker was able to reply that he was not at all surprised that Messrs. Blank and Hiatus were in a position to forego a commission, since at the time when the reverend gentleman was paying them 45*s.* per share, the shares in question could have been bought for him on the Stock Exchange at 40*s.* 6*d.* As he signed the letter conveying this information, his face was lit up with radiance as from above, and he evidently spoke the literal truth when he remarked that the incident was worth a week's commissions.

Concerning brokers' commissions, it may be remarked that hitherto the price charged for their services has been left to the arrangement of individual firms with their clients, but that lately there has been an agitation in the House for the fixing of a definite *minimum*, as a check on the practice of cutting commissions in order to compete for business. The Committee, sorely against the will of many of its leading members, drew up a scale which was produced early in 1910 for confirmation at a later date. When the date arrived it was not confirmed. In 1912 a minimum scale of charges was imposed, and is now rigorously enforced. The whole question bristles with difficulties, and would take a chapter (not to say a book) to itself, if

it had to be gone into thoroughly. For our present purpose it is enough to observe that to leave a pains-taking and well-informed stockbroker because his commissions are higher than those of a less able competitor is rather worse economy than buying bad boots cheap.

Compared with that of the broker the lot of the dealer or jobber is in many respects ideal. His working expenses are much less. He has no clients requiring presentable accommodation, and his office can be as inaccessible and humble as he pleases, and he is, as a rule, not in it for more than five minutes a day. His staff of clerks is much smaller, in relation to the volume of his business, than the broker's, for he has no correspondence to read and write, and copy and file. For the same reason he comes later to work and leaves earlier. The broker has to master his correspondence before business begins in the House. The jobber walks up to his office, says "Good morning" to his clerks, takes his dealing book and pencil, and the hat that he wears in the sacred precincts, and goes down to take his place in the market in time for the opening. There he stands all day, and he works hard during his short hours. Every sense is always alert to know the exact shade of price at which the securities on which his market specializes are changing hands, so that he may "make a price" to brokers correctly—a process which will be

described later—and at the same time he has to be quick to seize the attention of any brokers known to him who come up to the market, and not let them fall into the hands of a competing jobber.

The work that the jobber does is thus seen to lie in the fact that he makes, and is, the market: any broker who receives an order to buy or sell such and such stocks or shares, can go straight to a group of jobbers, any one of whom will buy from or sell to him, on terms which leave a small margin in favour of the jobber, which is called his turn, and so give him a chance of uncovering the bargain at a profit.

It is the existence of this turn or margin in favour of the jobber that causes the double quotation with which Stock Exchange prices are expressed. When Consols are about $81\frac{1}{2}$ they are quoted $81\frac{7}{16}$—$81\frac{9}{16}$, and the public often feels indignant and hurt because it finds that its business is habitually done for it at the higher price when it buys and the lower price when it sells. It consequently rakes up an old-time prejudice and accuses the Stock Exchange of robbing it, sometimes contrasting its practice with that of the circularizing philanthropists who apparently do business for the mere pleasure of obliging a fellow-creature.

The jobber and his functions, and the question

whether he earns his turn, have been discussed many times and at length, and I do not propose to revive the controversy in detail. The jobber's critics say that he exists in no other centre, and that his turn is an addition to the expense of dealing which the public habitually misunderstands and dislikes. His supporters retort that in no other centre is business nearly so varied, or is the number of securities dealt in nearly so great as in London; that London could not get through its day's business without the jobber, who enables the broker to go straight to a certain spot in the House and deal, whereas, if there were no jobbers, brokers would spend an hour or two every time they wanted to buy or sell in looking for a broker who wanted to do the opposite in the same amount of the same stock, and haggling about the price; and that the broker's difficulties would then be so greatly increased that he could not possibly work for the commissions now charged, so that what the public gained by the abolition of the jobber's turn it would more than lose by the addition to commissions and the slowness and difficulty of dealing.

This view of the case has been endorsed by the majority of the House itself, which in 1909 elected a committee with a mandate to make the rules stricter which defined the distinction between brokers and jobbers, and forbade members of

either class from encroaching on the business of the other. The same reform, or change, forbade brokers to carry out business except with a jobber unless they could show that they could thereby deal on better terms. This provision was aimed at a habit, which showed signs of growing, by which brokers with stock to buy or sell did their business with, for example, Anglo-American houses which were often in a position to deal in American bonds, or with the South African firms if it were a case of Kaffir shares, and so on. In so far as they did so, the jobber was starved, and it was maintained by the reformers of the Stock Exchange that it is to the interest of the House and of the public that the jobber should be fattened rather than starved, since by his presence he makes business quick and easy and keeps markets free.

So the House decided, but it must be remembered that the majority of its members are jobbers, and that consequently its testimony to his utility as an institution is not conclusive. Many of the leading firms were opposed to the reform, and preferred that business should be left to develop itself unshackled. But then, again, these leading firms were inevitably those which had done best under the existing system and so naturally wished that it should be maintained, even though it led to the ultimate vanishing of the jobber. Both parties in the controversy were rather

"talking their books," as the Stock Exchange would say, that is, were biased by their own interest, and it is very difficult for a disinterested observer to hazard an opinion. Nevertheless, with all the diffidence befitting a complex and technical problem, I venture to think that though all that is said concerning the utility of the jobber is true, it was a questionable policy to endeavour, by passing rules, to strengthen his position. If, as I believe, the jobber is an indispensable part of London's machinery owing to the diversity and magnitude of its business, his mere indispensability will be a sufficient safeguard for him as long as he fulfils his functions. At the same time if it be true, as seems very likely, that the multitude of jobbers has been increased out of all proportion to the advance of business, artificial measures for keeping business inside the House will not suffice to cure the evil of over population, and are quite likely to defeat their own object. The multiplication of jobbers, and the consequent reduction of their individual profits, has rather tended to diminish their utility and power to render the services for which the community pays them. The justification of the jobber is the fact that he provides a free market. He only does so by being ready always to deal, to take stock on to his book when the public is selling more freely than it is buying, and contrariwise. To do this, he requires

ample resources. If he has not got them, and consequently always has to keep his book even, and is shy of making prices in times of uncertainty or excitement—above all, if owing to inadequate legitimate business he has speculative commitments which make him even more nervous and eager to sell than the public if anything untoward happens—he simply cumbers the ground. The ideal jobber is a great merchant in securities, the nature and intrinsic merits of which he thoroughly understands. He is strongly backed financially, and is ready if the public rushes to sell to take the stock that it throws over, and if it rushes to buy to be short of stock, knowing that its ebullitions are short-lived and correct themselves with an inevitable ebb and flow. This kind of jobber really makes a free market and earns his turn. But he is also strong enough to stand without the help of rules framed for his supposed interest. Stock Exchange men, like all good Tories, are incorrigible "praisers of past times," and their Jeremiads on the present state of things must be taken with ample reservations. Nevertheless, there seems to be some truth in the general contention among thoughtful members, that this ideal merchant jobber is largely a figure of the past, and that his place has been taken by a horde of smaller men, who are small only because they are too numerous. If this be so, the blame

must be laid on the bad constitution of the House, which has placed its regulations in the hands of proprietors whose interest was best served by the rapid multiplication of members.

Finally, before we leave the subject of the Stock Exchange as a whole and proceed to look more closely into the details of its business, a word has to be said on another vexed question. Does the House fulfil its duty to the public in the matter of protecting it against swindlers, and seeing that the securities, in which it officially sanctions dealings, have some reasonable chance of earning something for their holders? Many old-fashioned members would flout the suggestion that the House owes any such duty to the public. They would tell you that it only has to see that the public can deal at market prices in any security that it chooses to handle, that the merits of the stocks and shares dealt in are not a matter which concerns the House or its Committee, that if the public likes to lose its money by investing in shin plasters and gambling in gold bricks, that is the business of the public, which must learn to take care of its money, and that any attempt by the Committee to pass judgment on securities would be laying a responsibility on it which it could not possibly be asked to undertake, and, moreover, would restrict business, impede enterprise, and bring in a wholly un-English spirit of official

regulation, red tape, and meddling, in a matter in which perfect freedom ought to prevail.

These arguments express the principle of leave-things-alone which was long dominant in English politics. It received its most notable endorsement from the lips of a right reverend prelate, who, in speaking on temperance legislation, said that he had rather see England free than England sober, and there is much to be said in its favour, especially in theory. But the theory requires that the community to which the principle is applied should be so wise and well-equipped, that all its individuals are able to arrive at a sound judgment for themselves, and need no guidance or government. In matters of temperance this is certainly not the case, and the consequence of the leave-things-alone principle is a terrible legacy of crime, disease, lunacy, and degeneration. In matters of investment and speculation the public is generally quite unable to judge for itself concerning the merits and prospects of securities, and there is a considerable body of opinion which holds that the Stock Exchange Committee, being a body of experts, might exercise much more supervision than it does over the securities that it admits to the privilege of a settlement, that is, officially allows to be dealt in in the House. The result of the present attitude of the Stock Exchange on this question is that, though it is composed of a body of members with

a very high level of business honour, its machinery is made use of by low company promoters and camp followers of the financial army to market wares which cannot bear inspection, and the public, which has not enough technical knowledge to trace the origin of the evil, lays it all at the door of the House. This is not good for the House, or for its business, or for the public, or for anybody but the predatory class which makes use of the opportunities thus given to it.

As usual the great example of the opposite policy of regulation and inspection is Germany In Germany the public expects to be drilled and pipeclayed and told what it may or may not do, and we in England, with our hatred of official meddling, like to laugh at the absurdities of the system and chuckle over Mr. Jerome's humorous example of the beetle solemnly removed from a grass plot by an official of a German public garden and hurrying off, looking very much ashamed of itself, down a path marked *Ausgang*. But we cannot afford to laugh at the system's results. Very likely they do much less business on the Berlin Bourse than we do in London, but at least the German public knows that any share which is launched in Berlin has something behind it in the shape of assets and profits which are not mere possibilities, but are actually achieved before the company can be promoted. It may be that all this regulation

checks enterprise and smothers many a project at its birth which might have grown to a lusty giant if it had not been strangled with red tape; but the achievements of German industry do not seem to show that this kind of supervision has a deadly effect. It is not suggested that London need take over in its entirety German strictness with regard to the securities that the public is allowed to handle. It should be easy to find a halfway house. The leave-things-alone policy brings and has brought on the Stock Exchange a great deal of blame and mistrust which ought fairly to be laid at other doors, and there is much to be said for the view that the House would greatly improve its reputation and prestige if it gave some attention to a matter in which it can speak with authority, and concerning which the investing public looks to it for guidance.

NOTE.—In this respect also considerable reforms have been effected since this book was originally published. See Supplementary Chapter.

CHAPTER IX

STOCK EXCHANGE TRANSACTIONS

IT sometimes occurs to curious investors to wonder what really happens when they give their brokers an order to buy or sell, and what are the inner workings of the mechanism by which they find themselves signing incomprehensible documents, and finally becoming possessed of securities or money as the case may be. It may help them to grasp the meaning of these mysteries if we trace one or two imaginary bargains from beginning to end.

Starting with an example of a bargain in registered stock, we will suppose that Mr. Roger Brownlow, of Broadlands, Loamshire, has been paid back £2000 which he lent on mortgage to a tenant, and has decided that he will put the money into some Stock Exchange security. He is one of those pleasant, comfortable clients, who know exactly what they want in a security, and can write and say it exactly and without vain repetitions. His mortgage has been paying him 4½ per cent.,

and he does not mean to take less on his money. So he writes to his stockbroker, Mr. Mainwaring Flasher, fourth in the direct line from Wilkins of that ilk who did Tony Weller's business, and tells him to buy on his account £2000 worth, more or less, of a well-secured stock that will yield a full 4½ per cent., and will not be subject to political influences, home, foreign, or international; for like the redoubtable Porthos, Mr. Brownlow always shudders when the word politics is mentioned. Mr. Flasher, whom the generations have toned down into a quietly dressed gentleman with a confidential manner that would make the fortune of a fashionable doctor, discusses his client's letter with his partner, and finally decides on Tasmanian Land 4½ per cent., First Mortgage Debenture stock; his partner observes that it is not many years since a series of droughty seasons and an Australian crisis put the Tasmanian Land Co. into a very ugly corner, and Mr. Flasher retorts that the interest on the First Mortgage stock was always punctually paid at the very worst of times; that the company had greatly strengthened its position in the good years that have followed the crisis, and that you cannot have everything if you want 4½ per cent. As he walks down to the House to do the business, he reflects that the stock which he wants is sometimes not very easy to get, and that the market in it is narrow and difficult.

Mr. Flasher is one of those brokers who have learnt their business from top to bottom, and take a real pleasure not only in finding good investments to suit their client's wishes, but also in dealing for them on the most favourable terms possible. Accordingly he first studies the Stock Exchange Official List of the day before, which shows him that the stock was then quoted at 97—99, and that business was recorded at 97¾ and 98½; he goes on to the marking-board, which gives the bargains already done on the day on which these events are imagined, and finds that not a transaction has been marked in Tasmanian Land 1st Debenture to guide him concerning the state of the market. As he walks through the House to the spot where he will find the dealers in land and finance companies' securities, he is continually seized on by jobbers in the markets that he passes, who ask him if he has anything to do; and his practised ear and trained memory stamp the apparently inarticulate roar of the market-place on his mind to such purpose, that by the time he has reached his point he knows the price to a hair of most of the chief stocks and shares in which active business is being done. This does not help him to the price of the stock that he wants, and when he comes to the group of jobbers that specializes in land and finance companies' securities, he hears no shouts of bidding

and offering to show him the state of the market. For in these securities, with one or two exceptions, there is no active speculation, and consequently the market is narrow, and a broker has to deal as and if he can. Flasher knows very well that he will probably not be able to have a price made, that is, be given the chance of buying or selling at two prices with a margin between them, but will have to put himself more or less in the hands of a dealer.

He walks up to the group with an air of indifferent unconcern, and looking as if he took a completely academic interest in the market, and is accosted by a jobber with the usual—

"Anything to do, Flasher?"

"Might deal if you're business."

"What is it?"

"Tasmanian Land 1st Debenture."

"97, 9 they call it."

"I want a price."

"Nonsense, old man; you know there isn't a price. There isn't any stock," says the dealer, knowing that Flasher is fond of putting his clients into this security, and is consequently a probable buyer. "I can buy any you've got to sell at 97½."

Flasher looks tired. "Don't be too generous," he says venomously; "they marked 97¾ yesterday."

"Also 98½," says the jobber with a grin.

Flasher looks still more tired and moves towards

another jobber. The man who has got him in hand seizes him and says—

"I can sell you a bit at 98½."

"Talk sense," says Flasher; "they marked 97¾ yesterday."

"At ¼ you'd be robbing me."

"At 98 you'd be robbing my client."

"There isn't any stock."

"Then why talk?"

"Say ⅛."

"I buy £2000 stock at 98⅛."

"How d'you expect a jobber to live?"

"You don't look much like dying. Besides you're not a jobber—never will be till you hire somebody to teach you your business."

Books and pencils come out and both parties enter the bargain. The jobber enters on the sold side of his book £2000 Tasmanian Land 1st Debenture Flasher 98⅛. Flasher on the bought side writes £2000 do. do., with Denman in the space left for the dealer's name, and Brownlow in the one which shows for which client the bargain was done.

Flasher then proceeds to "mark" the bargain, that is to say, to enter it on a slip of paper, which he signs and puts in a box. He thus ensures that the bargain shall be included in the official record of business done which is given in the Stock Exchange daily list. He is not obliged to do

so, and only a small number of the bargains done are actually marked and recorded. The official record is in this respect incomplete, and so sometimes misleads those who imagine that it covers all the transactions of the day. Nevertheless it is of some value to those who want to keep a close eye on the dealings in a stock, and it is a useful protection, to brokers who mark their bargains, against questions raised by the class of client that lives to cavil at everything that is done by its agents. Mr. Brownlow, looking at his paper next morning, sees that an official mark of $98\frac{1}{8}$ agrees with the price named on his contract and is satisfied. He also sees another mark at $98\frac{3}{4}$ and is still more satisfied. Flasher likewise sees the $98\frac{3}{4}$ marked, and smiles the complacent smile of a man who has deserved well of his client.

From the dealing-books carried by the principals the bargains are entered into the ledgers of the two firms. Flasher & Co. at once draw up a contract note stating that they have bought for account of James Brownlow, Esq., £2000 Tasmanian Land Co. 1st Debenture Stock at $98\frac{1}{8}$ for settlement June 10th, subject to the rules and regulations of the London Stock Exchange, and sign it Flasher & Co., members of the Stock Exchange, London. They add to the cost of the stock the amounts payable for the Government stamp on the transfer deed, the registration fee charged by the company, their

own commission and the Government stamp on the contract note. This note they send to Mr. Brownlow, with a letter informing him that acting on the instructions contained in his of yesterday's date they have purchased, etc., etc , and have pleasure in enclosing contract note.

Next day the bargain is checked. Every firm in the House has its checking clerk, who takes a book into which the bargains done on the previous day by the principals are entered, and checks them with every firm with which his has dealt. The checking clerks all meet at 10.15 in the basement below the Stock Exchange. The jobbers' clerks stand in groups at a recognized point like their principals upstairs, and the brokers' clerks go from group to group checking the bargains done by their firms on the previous day. The noise of the market-place is imitated in the checking-room by the jobbers' clerks shouting "Here Smith," "Here Jones," or whatever the name of their firm may be, and by the brokers' clerks shouting the names of the jobbing firms that they are seeking for in order to check bargains. A faint imitation of the chaff and horseplay of the House is also reproduced in the checking-room, though anything like serious fooling is frowned on as being a privilege of the members, not to be usurped by subordinates. Consequently Flasher's clerk, passing through the groups to check the bargain done on account of Mr. Brownlow, is

received with rounds of ironical cheers because he has girt his collar with a rather passionate green tie, but is not otherwise molested. The bargain is duly checked, Flasher's clerk saying, "We buy two* Tasmanian Land Firsts at 98⅛," while the jobber's clerk replies, "Sell you two Tasmanian Land Firsts at 98⅛."

When the account day draws near, Flasher's clerks make out a document called a ticket. The Stock Exchange account is a process occurring in the middle† and at the end of every month, and lasting four days. On the first day the carry over is arranged, a matter which only concerns operators who are not prepared to pay for stock they have bought or to deliver stock that they have sold, and will only concern us when we proceed to trace the course of a speculative transaction. The second day is ticket-day or name-day, on which the names and descriptions of the buyers of registered stock and shares are issued and passed by their brokers to the jobbers from whom the securities have been bought, and passed on by them till they reach the firm which is actually delivering the stock and shares, so that the transfer deed can be drawn up and signed by the parties. On the fourth

* "Two" of a stock means £2000 in the language of the House. "Three" is £3000, and so on.

† In the Consols market the settlement comes only once a month.

day (pay-day or account-day) transfer deeds are presented signed by the seller to the buyer's broker, who pays for the stock. The ticket drawn up for this particular transaction would run as follows :—

£2000 Tasmanian Land 1st Debenture Stock at 98⅛.

James Brownlow,
of Broadlands, Loamshire, Gentleman,
Flasher & Co. pay.

On ticket-day the settling-room clerks of the various firms take their seats at regular places in the settling-room, which is the big room in the basement used every morning as the checking-room, with a little box in front of them, into which tickets are put by the firms to which they have sold stock. Flasher & Co.'s clerk puts Mr. Brownlow's ticket into the box of Messrs. Denman & Freestone, the dealers who sold the stock. Denman & Freestone's clerks write on the back of the ticket the name of the firm which sold the stock to them, and pass it on to their box, and so it goes on its way until it comes into the hands of Messrs. J. and G. Simmery, who are delivering the stock, having sold it on behalf of Miss Angela Simpson. They proceed to draw up a transfer deed stating that—

I, Angela Simpson,
of 3, Grand Parade, Brighton, Spinster,
In consideration of the sum of £1962 10s. paid by James Brownlow,
of Broadlands, Loamshire, Gentleman,
do hereby transfer to him £2000 1st Debenture Stock in and of the Tasmanian Land Co., in witness whereof we append our signatures.

This is the gist of the document, but, of course, it is embellished with plenty of legal fluff besides. Having drawn this deed up, and got it signed in the presence of a witness by Miss Simpson, J. and G. Simmery present the transfer deed and certificate to Flasher & Co. on pay day, the last day of the account, or as soon after as the document is ready. Flasher & Co., having in the meantime received a cheque for the sum named on their contract, which included stamps and commissions, from Mr. Brownlow, pay the consideration money and the cost of the transfer stamp to Messrs. Simmery, who hand the proceeds, less their commission, to Miss Simpson. The transfer deed is then signed by the buyer, and afterwards taken to the offices of the Tasmanian Land Co. by one of Flasher's clerks, and is registered by its officials. They write to Miss Simpson and inform her that a deed purporting to have been signed by her, transferring £2000 1st Debenture Stock out of her

name, has been lodged with them, and that unless they hear to the contrary by return of post they will assume that it is in order. In due course Mr. Brownlow, who has now taken the place of Miss Simpson as the registered holder in the company's books, receives a certificate stating that he is the owner of £2000 1st Debenture Stock of the Tasmanian Land Co., and the half-yearly interest is duly forwarded to him, or to his bankers if he chooses so to direct, on April 1st and October 1st.

In order to make clear an expression which sometimes puzzles inexperienced readers of money articles, it should be observed that if a ticket as described above is not handed by half-past two on ticket-day to any firm which has sold registered stock or shares, the said firm is thereupon empowered to "sell out" the stock or shares, that is, to offer them through an official of the House to any one who will make a bid for them; the new buyer then hands a ticket giving the name, etc., of a buyer, the original bargain is void, and the original or intermediate buyer who has failed to pass a name in due time, is liable for any loss accruing to the seller, by a difference between the original and final prices, as well as being obliged to do his bargain over again.

In the same way, if the transfer deed signed by the seller is not delivered to the buyer by a certain time, his broker can make a fresh purchase. In

this case the time has to be longer, since it may take some days to get the signature of the transferor, and so "buying in day" is usually on the tenth day after pay-day in each account. On that day brokers to whom stock has not been delivered can "buy in" through the same official, who publicly bids in the market for the stock required, and, as before, the original bargain is void, and the seller who has failed to deliver has to answer for any loss that his failure to carry out the transaction may have caused.

It is thus evident that the machinery by which registered securities are transferred from seller to buyer is complex and confusing, and though it is handled with great ease and celerity by the cheery young gentlemen who turn its wheels to the chronic accompaniment of chaff and banter and anecdote, it makes a poor contrast with the sweet simplicity of the method by which bearer securities are transferred. Here there is no question of a buyer's name, address, and description to be passed on a ticket, or of a transfer deed to be drawn up and duly witnessed. All that is needed is that the name of the broker who pays has to be passed through to the broker who delivers, and then the securities themselves are handed over and paid for, and their possession conveys the title to ownership. Consequently, as was observed in a former chapter, very great care has to be taken of

them by their owners, who are well advised to put them in their banker's charge. It must be mentioned, however, that in the example taken of a registered stock transfer, we took a case in which the fullest complications of the matter were shown, because the stock was of a kind that is rarely dealt in, and, consequently, is not in the list of those handled by the Stock Exchange clearing-house. Stocks that are "cleared" have their passage from seller to buyer made much easier, in that all the firms which have done bargains in them during the previous account send lists of their transactions to the clearing-house, which crosses one off against the other, and delivers the name of the final buyer to the broker of the original seller, and so saves all the labour involved in its being passed through the hands of each intermediate party.

Having traced the course of a transaction by which a genuine buyer has become possessed of stock such as his heart desired, let us go on to a case in which the buyer buys not because he has money to invest, but because he has reason to think that the stock or share that he fancies will rise in price, and that he will be able to resell at a profit. In this case the process is at once simpler and more complicated. It is simpler in that the buyer does not pass his name or take up stock, it is more complex in that he probably has to carry the stock over, which is to

say, he has to pay some one else to pass a name and take it up. It is quite simple if he is lucky enough to be able to take his profit, or unlucky enough to be forced to cut a loss, before the settlement following the date of the bargain. If, for example, he buys 200 Chartered shares at 35*s.* on May 2nd for the May 15th account-day, and sells them again on May 10th, also for the May 15th account-day, either at 42*s.* or 28*s.*, the whole business cancels itself. As far as he is concerned, no shares pass from hand to hand. He has bought 200 and sold 200 If his brokers have carried out the two bargains with the same firm of jobbers, they become merely a matter of book entry between the two firms. If different jobbers have been employed, the clearing-house will cross off one transaction against the other. The net result is that the buyer either pockets a profit or pays a loss. But as it is, perhaps, more usual for a bargain to go on from one account to another, and as the whole machinery of the carry-over is puzzling to those who have never handled it or actually seen it at work, it will be better to try to make it clear with another imaginary bargain on behalf of Mr. Brownlow. We will suppose, then, that he has an old schoolfellow who is settled in Johannesburg, and sometimes sends him information concerning likely gambles in South African mines, and now hears from him that Rooikop Deeps are very

well thought of by knowing folk on the field of action. He sends an order to Flasher to buy one thousand of the shares, informing him at the same time that he does not intend to take them up, that is, pay for them and put them into his name. He could do so easily enough if he wished to, and it must not be supposed that by any means all the operators who carry over shares do so because they have not got the money, or the wherewithal to raise it. He does not wish to sell other securities in order to take up shares that he does not mean to hold long, and he has a healthy dislike for borrowing from his bank, and so he intends to carry over his Rooikop Deep unless he is lucky enough to make a profit on them at once.

Flasher's task in buying Rooikop Deep is a very different business from the tactful negotiations with which he had to feel his way towards a purchase of Tasmanian Land Debenture stock. Instead of a narrow market composed of half a dozen dealers who only turn stock over when it is really bought or sold, he has to go to the boiling whirlpool of the Kaffir Circus, then in one of its most ebullient epochs, a crowd of shouting dealers, amongst whom shares are being tossed from hand to hand, or from book to book, by hundreds and thousands from long before the official opening of the House until long after the market has been

turned out of doors and is continuing its uproar in Throgmorton Street. The official marking-board is of no use to him now, for Rooikop Deep is not officially quoted. But he does not need its help, for the shares in which he now has to deal are of the volatile and active variety, with a free market and a fine price, which can very easily be discovered. In fact, Flasher, as he walks towards the South African market, meets his own authorized clerk, who has been collecting prices in the active markets to telegraph them to country brokers, and learns from him that Rooikop Deep are called seven nine, and that he thinks they are buyers under a half. Which being interpreted in the vulgar tongue means that the quotation is $1\frac{7}{16}$, $1\frac{9}{16}$, and that the exact shade of the market is fifteen thirty-seconds (a thirty-second under a half) bid.

On the outskirts of the market Flasher is seized by a jobber, but shakes his head and passes on into the thicker depths of the throng. He wants to deal well, and he knows that to do so he has to find a dealer who has business in the shares and can make him a really close price. He finally allows himself to be taken hold of by one Jenkins, a grizzled veteran, popularly known as "Always Business," who gives him a whimsical look out of a searching but inexpressive eye, and says—

"What is it, Flasher?"

"What are Rooikop Deeps?"

"Seven, nine."

"I want to deal."

"Well, you can."

"Not like that."

"Seven sixteenths to over a half."

Flasher shakes his head and looks like moving to another jobber.

"Either side of a half."

"You're a long time coming to business."

"P'raps you'd like your choice at the middle?" This with elaborate sarcasm.

"Hurry up, Jenkins."

"Hang it, under to a half."

"Thanks, I buy a thousand. Shouldn't be out of them if I were you. My client sometimes knows what he's doing in Kaffirs."

"Nice obliging gentleman you are," retorts Jenkins. "You squeeze me till I can't possibly make a turn, and then give me fatherly advice."

A full translation of the above dialogue would show that Jenkins originally made a price to Flasher of $1\frac{7}{16}$, $1\frac{9}{16}$; that is, was prepared to buy at $1\frac{7}{16}$ and sell at $1\frac{9}{16}$, leaving a margin of $\frac{1}{8}$ in his own favour; and that Flasher, by repeated refusals to deal, impelled him to narrow the margin down until the price finally made was "under to a half," which means $1\frac{15}{32}$ to $1\frac{1}{2}$, whereupon Flasher bought his shares at $1\frac{1}{2}$, having during the course of the

brief discussion saved his client 1000 sixteenths, or £62 10s. The object of the jobber, of course, is to make a price as wide as possible, that is, with the largest possible turn in his favour, and contrariwise, that of the broker is to narrow the margin down to its finest limits. Throughout the process of bargaining Jenkins did not certainly know whether Flasher was a buyer or a seller, and this is the essence of Stock Exchange dealing, that the price is made, in securities in which the market is free enough to permit of it, without the broker disclosing the nature of his business. Many jobbers are said to acquire an almost uncanny faculty for reading their brokers' countenances, telling at a glance whether they are buyers or sellers, and making prices accordingly, and many stories are told of the ingenuity with which the two classes of members outwit one another in the course of this curious and unique kind of dealing. Many years ago a very astute old broker, of Dutch extraction, had a business which was almost entirely confined to American shares and foreign bonds. One day he walked up to the leading jobber in the heavy * section of the Home Railway market and produced a certificate for £1200 London and North Western stock. He explained, with his foreign accent very much turned on for the occasion, that he did not

* In which stocks of the big trade lines are dealt in.

understand Home Railway stocks, that he was only accustomed to dealing in bearer securities, and that he did not know what the certificate meant. "That's all right," said the jobber, "it's £1200 Brums, London and North Western, the line that takes you up north when you go shooting grouse. It's about 152—3. Half a moment, I'll see what the exact shade is and make you a price."

There could not be any doubt that the broker was a seller. Here he was with the certificate in his hand, which his client clearly wished to turn into money, and the jobber, returning after a moment, made the price two to a half, putting it "on the ground floor," as he always said in telling the story against himself, as far as the limits of fair dealing would allow.

"Ah so," said the wily broker with a glimmer of a smile in one corner of his mouth, "then I buy £1800 stock of you at 152½." His client had wanted to add to his holding, and the ingenuous production of the certificate had been a carefully thought out ambush into which the jobber had incontinently walked.

Another story of the fencing that goes on all day between brokers and jobbers tells how a broker, with a telegram in his hand, was trying to squeeze a jobber into making a fine price when the jobber, supposing that the telegram gave

full instructions, said, "I'll make you a sixteenth price if you'll show me your wire."

"Right," said the broker, holding out the telegram, which read, "Close my Brighton A."

To return to our transaction, its early history is very much like that of the former example by which a real purchase was made. The bargain is checked in the same way on the following morning, and a contract is sent to Mr. Brownlow on the same lines, except that this time he will not be charged for stamps and fees, since there will be no transfer of stock into his name. All that his account will be charged with will be the price of the shares bought plus the commission and the contract stamp

As account-day draws near there is no ticket to be made out, as far as Brownlow is concerned, since he does not propose to take his shares up, but by carrying over his shares, through his broker, in the market, to hire somebody else to do so for him, by payment of what is known as the contango rate, or continuation rate. In the first transaction that we traced on Brownlow's account he was a real buyer of stock for investment. Now he is a Bull, who has bought shares which he expects to rise in price, and does not mean to pay for them, but to sell at a higher level if he can. Stock Exchange practice, however, ordains that there is no such thing as an uncompleted bargain. Flasher & Co. have bought 1000

Rooikop Deep at 1½ for end-July Settlement, and are bound either to pay for them, or to find somebody else who will pay for them, or declare themselves defaulters. Since their client does not intend to pay for his shares, and they have no intention of declaring themselves defaulters and being hammered,* they find some one else who will pay, through the machinery of the "carry-over." That is to say, on the first day of the account, which, as we have seen, begins on the mining markets a day before it is entered upon in other departments, Flasher & Co. have to "give on" 1000 Rooikop Deep. They are "givers" because they have to pay the rate for carrying over, to some one who will enter into a bargain with them, binding himself to buy the shares from them for cash or immediate settlement, and sell them again for next account, at a price which is called the making-up price, charging a rate which is called the contango, or continuation, rate. The making-up price is fixed by the leading jobbers in the various markets, and roughly represents the price at which the security in question is quoted

* This expression, denoting failure on the part of a Stock Exchange firm, is derived from the three strokes of a hammer on his desk, with which the waiter obtains silence before announcing the name of a firm that "has not complied with its bargains." There is something very awesome about the hush that falls on the House on these occasions. Nothing but the sound of the hammer ever reduces it to real silence.

at twelve o'clock on the morning of the carry-over day. The simplest way of carrying out this business is for Flasher to carry the shares over with "Always Business" Jenkins, the jobber from whom he bought them; thus the bargain of purchase from Jenkins would be balanced in the firm's books with the carry-over bargain on the opposite page, and their dealings as far as this account is concerned would be settled by a cheque for the balance in either direction. But Flasher is a keen broker, anxious to do his very best for his client, and he knows that he may carry the bargain over rather more cheaply, that is, pay a contango of perhaps ½ per cent. less, if he goes to one of the many firms of brokers who employ their own money and that of their clients by lending it in various markets on contango, paying for shares on behalf of bulls who do not want to pay for them themselves, and earning the comparatively high rates that are to be got in this kind of business.

So, early on the morning of carry-over day, which is July 24th, Flasher goes down into the House and finds a knot of brokers by the Kaffir market, among whom he seeks the representative of Jones, Brown & Co., a big firm of money-lending brokers, and arranges with him to carry over 1000 Rooikop Deep at 6 per cent. That is, Flasher & Co., the "givers," sell 1000 Rooikop Deep at the

making-up price of the day to Jones, Brown & Co., the "takers in," for account July 28th, and buy them back from them at the same price for account August 11th, paying them 6 per cent. on the value of the shares for fourteen days. By this method Stock Exchange practice is complied with, and Flasher's original bargain on Brownlow's behalf is completed. Flasher receives from Brown, Jones & Co. a ticket setting forth the name and address of the party who is prepared to take up the shares; this name is passed on to Jenkins, from whom the shares were bought, and passed on by him to his seller, until it finally reaches the broker who is delivering 1000 shares on account of a real seller In the meantime Brownlow's bargain is continued for him by this process, which sells his shares for the current account and buys them again for the next. If we suppose that there has been a drooping tendency in the Kaffir market since he bought, and that the making-up price of Rooikop Deep is fixed at $1\frac{3}{8}$, the carry-over contract note furnished to him by his brokers will inform him that they have sold on his account for settlement July 28th 1000 Rooikop Deep at $1\frac{3}{8}$, and bought on his account for settlement August 11th 1000 Rooikop Deep at $1\frac{3}{8}$.

The carry-over bargain thus roughly balances the purchase for purposes of the present account, and Brownlow has a cheque to send to his broker

representing the "difference" against him arising out of the difference of $\frac{1}{8}$ in the price at which Rooikop Deep was "made up" and the price at which he bought, plus commission and contract stamp, and the rate that he paid for continuing his bargain, in other words, getting some one else to pay for the shares and hold them for the next fortnight until the ensuing settlement. Having paid his difference, he starts the next account a bull of Rooikop Deep at $1\frac{3}{8}$, and we may either suppose, if we like to take a cheerful view of the matter, that his information was well founded, and that the early discovery of a wide, rich reef puts the shares up to 2 and enables him to close the transaction at a pleasant profit, or, if we are pessimistically inclined, we may imagine that the drooping tendency went on, that nothing happened to make anybody want to buy Rooikop Deep, and that Mr. Brownlow finally sold in disgust at $1\frac{1}{8}$, a sadder and a wiser man, having lost in all about £500 in differences, contango money, commissions, and contract stamps, and not even having had a "run for his money."

Some brokers formerly charged a commission for carrying over, usually half the scale for purchases or sales, but made no charge for the final bargain which closes the transaction. This arrangement however is no longer customary.

By this detailed account of the machinery of

the carry-over, it has been shown that the bull, who carries over shares which he has bought, borrows money from somebody until the next settlement, and that the said somebody engages, in return for the contango rate paid by the bull, to take the shares up for the time being, buying them for the account then being arranged and selling them again for the next, both purchase and sale being at the making-up price. In order to carry over the bull has to borrow money, and if there are very many bulls of a particular security, their competition to borrow money will force up the price that they will have to pay, in other words, make the contango rate rule high. Hence it is that the level of contango rates is always regarded as an important indication of the state of the market in a stock or share. If contango rates are exceptionally stiff, it is clear that there is a large number of bulls who want to carry over, and, consequently, want to sell at any advance, or may be forced to sell by any adverse news which might frighten them concerning the prospects of the security in which they are speculating. So that a high contango rate and a large number of people wanting to carry over imply that the market in the stock affected is a weak one, since it is liable to be suddenly depressed by realizations on behalf of operators who have bought only with a view to selling again.

As the bull borrows money, and pays a rate to some one to induce him to take up stock or shares for him, contrariwise the bear borrows stock, or, in the technical jargon of the mart, "takes in" stock, and at times when there are very many of them, pays a rate which is called a backwardation to some one to induce him to deliver stock or shares for him. The bull buys stock to sell again; the bear sells stock which he has not got, or does not propose to deliver, with a view to buying it back more cheaply when some event or chain of circumstances, which he thinks that he foresees, has depressed its price. The bear is thus a fictitious seller who, not having stock to deliver, does not want to be paid for it, and, consequently, is in a position of a money lender and can as a rule expect to be paid the contango rate by a bull. For, since he has sold stock and does not want to be paid for it, he is able to accommodate a bull who has bought stock and does not want to pay for it, by temporarily crossing off his bargain against the bull's, just as well as a genuine money lender, who is prepared to take up the bull's stock. When this mutual accommodation is carried out between the bull and the bear, the bull normally pays a contango rate to the bear, because the practical result of the bargain between them is that the bull lends the bear stock and the bear lends the bull money, and in normal circumstances the temporary use of money entitles

the lender to a rate of interest on it, whereas the temporary use of stock carries no such advantage. If, however, there are very many bears, or more bears than bulls, the demand by the bears for the stock that they want to take in, enables the bulls to make them pay a rate called a backwardation, or, more briefly, a back, on stock that they have to borrow. Since the supply of any given stock is evidently limited, whereas, if rates for money are sufficiently tempting, it is easy enough in normal times to attract an increased supply at a price, the bears are much more likely than the bulls to defeat the object of their own campaign by their own numbers, if there are too many of them.

For instance, let us take the example of a stock with a total amount of £50,000. If a hundred optimists thought that it was going higher, and bought £1000 apiece, they would be bulls of twice the capital, but there would be no difficulty about finding £100,000 at a price for carrying their commitments; but if, contrariwise, a hundred pessimists thought that the stock was likely to fall, and sold a thousand apiece, the only people who could lend them the stock would be the real holders of it—most of whom would probably be quite unaware that any unusual transaction was afoot in it—and the buyers who had purchased from the bears; consequently, the competition among the bears to take in their stock would raise the backwardation

on it, probably to a prohibitive height, and they might easily be forced to close most of their commitments at any price that the bulls chose to dictate. So it falls out that bears, if there are too many of them, tend to create a corner against themselves. "When I am a bull," said a well-known operator who has made and lost two or three fortunes at the game, "I open a magnum with as many of my friends as will join me; when I am a bear, I take a liqueur glass by myself."

This attempt to explain a highly technical and complicated matter was necessary because the level of contango rates, and the occasional appearance of a backwardation, are very important indications of the state of markets, which have to be followed carefully by those who wish to forecast their movements. When contango rates are high the presence is indicated of a big bull account, and of a large number of speculators who want to sell, and so are a source of weakness; when they rule low or run off to "even"—that is, when bull and bear accommodate one another for nothing—and still more when the contango paid by the bull is turned into a backwardation charged to the bear, the inference may be drawn that the stock is oversold, that there are a large number of speculators who will have to buy it back some day, and so are a source of strength to the market. So much so that a determined demonstration by the

bulls, a piece of good news, or a favourable rumour cunningly circulated may start a successful bear hunt, and compel those short of stock to bid the price up with a rush in their haste to cover their commitments.

Continuation rates and the state of the account on carry-over day thus throw useful light on the internal condition of markets, but it is commonly alleged that they are not nearly as trustworthy guides as they were of yore, owing to the modern fashion by which speculators do not carry over stock in the House, but pawn it with their bankers, putting it into the manager's name, and raising a loan on it. These facilities enable the bulls to arrange their commitments without any supervision on the part of the Stock Exchange, so that a market may be apparently quite clean, and free from anything like an unwieldy bull account, while there may be in fact a large number of operators who have pawned stock with bankers and are only awaiting a good opportunity for selling it.

CHAPTER X

THE MOVEMENTS OF SECURITIES

PRICES of stocks and shares go up when there are more buyers than sellers, and go down when there are more sellers than buyers. This seems to be a fairly safe platitude with which to begin a chapter on price movements, and yet even it is not quite true, for prices sometimes rise and fall merely because the dealers think that there are going to be more buyers than sellers, or contrariwise. This immediate overthrow of our opening platitude is really very helpful towards the solution of the problem of price movements, because it brings us face to face at once with the fact that what people think about a stock is the most important item in the bundle of causes that control its movements; in other words, that price movements are chiefly a psychological question. "There is nothing either good or bad but thinking makes it so," says Hamlet, and if he had lived to-day and applied his genius to such sordid matters, he would have told

us that the future course of the rubber market largely depends on what a certain number of people are going to think about its prospects.

When it is merely a question of the dealers in a market thinking that the public is going to buy or sell, and, consequently, quoting higher or lower prices, the effect of their thought on quotations is soon either sanctioned or amended by the action of the public. For example, it often happens that an unexpectedly favourable traffic return or dividend announcement makes the dealers in a market raise the price of a stock because they infer that a quick rush of buying will follow it, and that it turns out in fact that speculators prefer to take advantage of this good news by securing profits, which they do by selling the stock. Thus the immediate result of an encouraging turn in the fortunes of a security may be a tumble in its price, merely because a large enough number of people think that this is a good opportunity for selling. But this kind of topsy-turvy effect is usually shortlived. If the outlook for a stock has really been improved by the announcement, the realizations by speculators who had backed the chance of improvement and sold when it was achieved, are likely to be followed by purchases by a fresh band of holders or bulls, if a large enough number of them think that the stock has tumbled too far.

One curious result of this dependence of securities on public opinion in the matter of their price movements, is that it is often dangerous to be too clever and far-seeing concerning the influences that may be expected to improve or depress prices. It has happened before now that long-sighted operators have foreseen trade development or other happenings that could not fail ultimately to have an important effect on prices, have backed their opinion by buying the securities likely to be affected, and have lost money by being too keen of vision. All that they foresaw may have happened, but if its effects did not dawn on the intelligence of a large enough number of buyers, the stocks that ought to be affected would not move. In the meantime the far-sighted operator would have a certain amount of capital locked up, or would be paying rates for the use of borrowed funds in order to carry his purchases, and might, perhaps, even be forced by some chance blow of fortune to sell out before his perfectly correct forecasts had been grasped by a large enough number of his fellow-creatures to enable him to benefit by them. It is not enough for a stock to be worth buying. It must be recognized to be worth buying by the multitude before it will go up in price. Further, the fact that a stock may be absurdly over-valued will not for a moment prevent its rising still further if there are folk

enough who believe that it is still cheap and are prepared to back their opinions by buying it.

For example, in 1895 there were many that said that it was sheer madness to pay £5 per share .or the shares of the Chartered Company of British South Africa. In one sense, as later events proved, they were perfectly right. Any one who then bought and has held ever since has had not a halfpenny worth of dividend, has seen his shares fall below £1, and now, July 1910, sees them standing at about 30*s*. In another sense they were quite wrong. For though, on a calm survey of the prospects, it may have been mad to buy at £5 in 1895, an operator who did not care a button about prospects, but saw that the public had gone mad about Chartered and would continue to go madder, and had consequently bought with a view to selling to some still madder madman later on, would have been handsomely rewarded by the economic Providence, and have been enabled to sell out later at a comfortable profit of over £3 per share, since Chartered rose to nearly £9 before the movement had spent its fury.

It need hardly be said that this possibility of a craving by the public which will raise the price of a security to a level which can only be justified by inordinately optimistic fancy, can only come into being in the case of more or less speculative ventures. Such an outburst could not occur, for

example, in the case of Consols, or of any security on which the rate of interest or dividend is fixed, and is very unlikely to occur with regard to the ordinary stocks of companies engaged in commonplace industrial or business ventures, working under normal conditions of competition, which tend to limit the extent to which their earning power can grow. When the public fancy is stirred to enthusiasm by a possibility like that of the Chartered Company's property, thousands of square miles which were, in 1895, believed to be teeming with gold and precious stones and ready to wave with bounteous harvests; then, since it is all a matter of belief and imagination, there is no limit to the price that operators who have been bitten with the mania will be prepared to pay.

When you are capitalizing a *perhaps* which you believe to be infinite, the number of noughts that you add on to the market value of the Company's capital is a matter that does not concern you, as long as you are wrought up to the right pitch of excitement. There is nothing by which the valuation can be tested, for it is all based on profits that are alleged to be going to be earned some day. The market simply riots at its sweet will, as long as there is a sufficient supply of enthusiasts who will back fancy estimates with hard money, and ot speculators who see that the enthusiasm is likely to endure for a time, and buy shares to

unload them on to the next set of enthusiasts. Since the current value depends entirely on surmise and imagination, there is no test of intrinsic merit that can be applied to sober the market's imaginings, and the economic law which makes possessors of a commodity usually inclined to sell it when it rises, is modified or sometimes quite abolished for the time being in the case of a security the value of which is based on possibilities. The higher it goes, the more it strikes the public imagination and makes folk talk about it and its alleged prospects and rush in to buy. Similarly, when the ebb of the tide comes and the movement is downward, the more this kind of security falls the more those who have got it feel inclined to sell it, merely because the sight of its fall makes them doubt concerning the myths that have grown up around it.

All securities, even the soberest and steadiest, are affected more or less by this economic eccentricity which makes folk inclined to buy them when they are rising and to sell them when they are falling; the eccentricity arises from the complication by which human feeling plays so important a part in the price of securities. If we want boots and they are offered cheap, we buy them all the more readily. If we want a stock and it is offered cheap, we begin to be not quite so sure that we do want it, and to wonder whether the

stock can be quite as good as we thought, and whether some other would not be better. If a stock suddenly falls heavily, it is more than probable that the immediate result of the movement is a further fall, especially if a large amount of it is pawned or borrowed on; for the borrowers have to provide more margin* or else the security is at once sold by the lender. Moreover, a large number of real holders would probably be frightened into selling at once, while the real buyers who might come to the rescue, would be hesitating and making inquiries, to make sure that the security behind the stock had not been impaired, and that the fall was only due to external circumstances. But of course it need not be said that the more solid is the position of a stock the less it is liable to variations in public sentiment on the subject of its merits.

When we say that the most important influence on the price of a stock is what the public thinks about it, we must qualify the statement by observing that the public here means the public with money in its pocket. It is the excess of

* For instance, if you borrowed on £10,000 Consols from your banker, he would want a margin, let us suppose, of 5 per cent. on the market value. If the price were 80, market value would be £8000, and he would lend you £8000 − £400 = £7600. If the price dropped to 75, market value would be £7500, and your margin would be gone. You would have to produce more security or money, or the banker would sell your stock.

buying over selling that raises prices, and it is of no use for a large number of people to think that they would like to buy if they could. As the jargon of economic science would express it, the demand must be effective. It takes very little money to enable a speculator to buy securities as a bull; he only has to convince a stockbroker that he is in a position to pay differences that may be against him, and he can buy freely and heartily, and for the moment his purchases will have just as much effect on the market as if they had the Bank of England behind them. But only for the moment. The bull who cannot or does not take his stock up, or get it pawned with his banker, has to show his hand when carry over day comes round, and then it is seen that there is so much stock bought only to be re-sold and that the market is a weak one to this extent; and finally, when he takes his profit or cuts his loss, his selling depresses the price by just the same extent as his purchase has raised it. It may appear to have more or less effect owing to the number of other people who may be operating on the same, or the opposite side of the market; but, as a matter of arithmetical fact, every bull position closed must undo its own original effect, as far as the actual state of the market is concerned. At the same time, purchases by bulls may have a good deal of psychological influence, by calling

the attention of operators who are able to make real purchases to the merits of a stock, and so bringing forward a rush of real buyers with money behind them. It is a commonplace in the City that the public only buys on a rising market, and though this is perhaps not as true as it used to be, because the public is becoming very much more sensible on these points, thanks to bitter experience and hard lessons slowly learnt, yet the fact remains that a sharp rise in the security due to buying by operators in search of quick profits, calls attention to it and makes the papers and the public talk about it; and then folk who have money to invest, or are fond of trying to increase their capital by changing their investments, begin to look into it and ask their brokers and their knowing friends how much real basis there is for the advance. So it follows that though the only buying that has real permanent effect on prices is that of those who can pay for stock and take it up, the purchases of the gambler for differences will often point the way for the real buyer, and produce a state of public opinion which leads to purchases of the more genuine order.

In fact, it may be said that this is the normal course of events in market movements that are accompanied by speculation—that speculators, generally of the professional and well-informed class, anticipate good or bad news by purchases or

sales, and close their commitments when the good or bad news arrives and produces buying by investors or sales by holders, while at the same time there is often an aftermath of speculative buying in the case of good news, by members of the outside public, which more often than not loses its money by coming in too late, or, in the expressive Doric of Throgmorton Street, "gets landed at the top." This kind of speculator very rarely indulges in a bear operation, partly because he is by nature an incorrigible optimist, and partly because he does not, as a rule, quite understand bear operations or see how it is possible to sell stock that he has not got. He is like the character in the old-time farce who was advised, if he wanted to make money on the Stock Exchange, to sell Trunks, and first replied that he had only got a carpet-bag and a hat-box, and then when he had grasped the nature of the operation advised, went and bought a large line of Grand Trunk Railway Stocks, arguing that he could not possibly sell them before having bought them.

There is also a curious sentiment among speculators of the more unsophisticated class that there is something rather questionable and immoral about selling stock for the fall, whereas buying it for the rise is a quite respectable and rather praiseworthy act. Probably this notion arises out of the thoroughly healthy prejudice against folk who always look at

the dark side of the picture and are quick to detect weak spots in their friends and in things in general, and so are born with a bearish turn of mind. In fact, there is nothing more immoral about selling stock that one has not got than about buying stock that one does not propose to pay for, and it has already been shown that the existence of a bull account is a source of weakness to a market, since it means that there are a large number of people who want to sell, while the existence of a bear account is a protection and support, since it implies that if any bad news is received, there are a number of folk waiting to close commitments by buying back stock of which they are short. It need hardly be said that the real speculator who speculates as a business and makes a science and art of it, and is the only person who as a rule and in the long run makes anything out of it, does not narrow his activities by confining himself to the bull or bear side of the market, but changes from bull to bear as the conditions and outlook may tempt him, and is often enough a bull in one market and a bear in another.

We have also seen that the effect of bull and bear operations are more or less temporary, and that what finally determines the price of a security is what the real investor thinks about it. Bulls and bears produce the waves on the surface, real buying and selling are the flow and ebb of the

tide which determine the mean depth of the water. This being so, it is evident that we can only arrive at a clear notion of the influence that moves prices by considering who the real investor is, and by what mental process he arrives at conclusions about securities. The real investor is in most cases a member of the upper or middle classes of society, and so is likely to be unconsciously guided by convention and what he believes to be correctness; he is also, usually, gifted with a rather limited outlook; for the people who are doing the big things of the world and are engaged in the pursuits which develop the full range of the intellect, are generally not themselves investors, but if they are troubled with money matters, leave the whole charge of them to some trusty henchman in whom they have confidence. It is not necessarily the owner of money invested, but the man who actually handles it and decides where it is to be put, who finally determines the prices of securities.

Further, the investor is more likely than not to belong to the Unionist party, since its ranks are largely recruited from the upper and middle classes, from which the investor usually comes; and this is a very important fact now that politics and finance are becoming so hopelessly entangled, and has a very direct and telling influence on prices. For instance, ever since Mr. Chamberlain

contended that British industry is doomed and dying unless it is rescued by Tariff Reform, the great body of investors believed what he said and have consequently been shy of home securities; and this shyness was greatly enhanced when a Liberal Government came into power and made fiscal arrangements which were novel in design and far-reaching in effect, and were denounced by Tory champions as Socialistic and calculated to undermine British credit. Investors, many of whom were undoubtedly frightened by the Budget of 1909, took all that was said by their party leaders as gospel, and sold their home securities in a hurry and sent their money abroad, and then the Tory orators were able to point to the consequent fall in the prices of home securities as conclusive proof of the truth of all that they had been saying, and of the wickedness of their adversaries' measures. Having frightened investors into selling, they proceeded to demonstrate from the fall in prices that the cause of the terror had been genuine. And so investors sold more and more, and became more frightened by the effect of their own fright, and men of light and leading in the City, who were among other things Tories, made eloquent protests against measures calculated to destroy confidence in the security of property, and lamented the fall in the prices of home securities and the hurried export of British capital, which were in

fact partly due to a sentiment which they themselves and their party leaders had done much to foster. Consols became a stick to beat a Radical Government with, and it was all very amusing and rather wicked, but fair enough tactics as the game of politics is played. The net result of it all was a depreciation in British securities, Governmental, municipal, railway, and industrial, which brought them tumbling down from the certainly exaggerated level to which they had been raised by the effect of previously current convention and fashion, and also by legal enactment.

Old-time convention had been very much in favour of investments at home, and there was a time when no self-respecting investor thought his outfit of securities complete without a fair holding of Consols, and a certain amount of Home Railway stock was also an almost inevitable item in the parcel. The regulations laid down by law for the guidance of trustees in the selection of securities had the same tendency, since they did not permit any investment abroad, except in the obligations of the Indian Government, until, in 1900, they were modified, at a moment of Imperialist enthusiasm — another example of the effect of politics on prices—so as to include the loans of British Colonies. Perhaps the first event to make a breach in the wall of the convention in favour of home securities was the conversion of Consols by

the late Lord Goschen in 1888, which brought down the rate of interest on them from 3 per cent. to 2¾ per cent., and then 2½ per cent. Many old-fashioned holders misunderstood and disliked the measure, and were naturally tempted by it to sell their Consols and buy some other security in order to avoid the loss of income that had to be faced if they made no change in their holding.

The spell of Consols was broken, and that tendency arose which has since then grown and thriven, under which investors began to think rather less of security and rather more of high interest, and to wonder whether, by enlarging their horizon, they could not increase their incomes without running undue risks. This tendency was quickened by a chain of abnormal circumstances which had an extraordinary effect on the money market, and made money astonishingly cheap, and so carried Consols and other stocks of the trustee class up to a point at which they gave a yield of 2½ per cent. and less to the buyer.

Many holders of these securities were tempted by the rise to get rid of them and seek more comfortable incomes elsewhere, and so the process begun by the conversion was quickened. But the general opinion of those times was that the rise had come to stay, that capital would have to put up with a permanently lower rate for its use, and that 3 per cent. on trustee stocks would never

come again in our time. Consequently, trustee stocks became more than ever unpopular when all these forecasts proved to be wrong, and a fresh chain of circumstances, including the South African War, raids on the Sinking Fund, and high taxation due to the war, which made a higher yield on capital still more desirable to those who were free in their choice of investments, brought Consols down from 114 (touched in 1896) to below par, and tumbled other trustee stocks down with almost equal celerity. This fall robbed the leading home securities of the attribute of steadiness and stability with which their admirers had gifted them, though a look into their past history would have shown that they had little real claim to it, and so knocked another nail into the coffin of their good fame. Then came the political influences already referred to and the energy of Tariff Reformers in asserting that British industry is dying, and can only be saved by their remedies, and then later, that British security is being undermined by the revenue-raising measures of the other party. Since these revenue-raising measures included the imposition of a super tax on incomes of over £5000, they directly quickened the process of investing abroad by tempting capitalists to buy foreign securities, and leave them in the hands of foreign agents and allow income on them to be reinvested by the said foreign agents, so that they

need not include it in their statement of income received.

All these tendencies have inevitably led to a levelling down of English securities, and a levelling up of the foreign ones which were bought by English investors in exchange for the stocks that they quitted in disgust. So the politicians have been able to use these concurrent movements as proof of their contention that there is something rotten in the state of England, and that other countries basking in the sun of Protection are really happier and more prosperous. The consequence is a very dangerous feeling of national and individual diffidence. Englishmen are being taught to believe that they belong to a poor, decrepit old country, and that they themselves are inefficient people, lacking in all the qualities of the good citizen. Our foreign rivals seize with delight on these alleged proofs of our decay, and a German writer is said to have composed a telling monograph on English decadence, the case for which is proved entirely by quotations from the speeches and writings of English public men.

There is comfort in the fact that this kind of sentiment has been very rife among us before now and at periods when it was promptly shown to be quite without foundation. Burke, in his "Letters on a Regicide Peace," recalls that "in the beginning of what has lately been called the Seven Years'

War, an eloquent writer and ingenious speculator,* Dr. Browne, upon some reverses which happened in the beginning of that war, published an elaborate philosophical discourse to prove that the distinguishing features of the people of England had been totally changed, and that a frivolous effeminacy was become the national character. Nothing could be more popular than that work. . . . Whilst we were thus abandoning ourselves to a direct confession of our inferiority to France, and whilst many, very many, were ready to act upon a sense of that inferiority, a few months effected a total change on our variable minds. We emerged from the gulf of that speculative despondency, and were buoyed up to the highest point of practical vigour. Never did the masculine spirit of England display itself with more energy, nor ever did its genius soar with a prouder pre-eminence over France than at the time when frivolity and effeminacy had been at least tacitly acknowledged as their national character by the good people of this kingdom."

Certainly the feats and glories of the Seven Years' War were a very handsome answer to Dr. Browne and his followers. It may be that fate has in store for us an equally striking refutation of the

* Used here in the old-fashioned sense of thinker—though Dr. Browne may very likely have been likewise an operator on the bear side.

national pessimism; but in the meantime there can be no doubt that it is doing its best to make itself true. At the present moment, however, all that concerns us is its effect on the mind of the investor, who comes from the classes most likely to be susceptible to its influence. This effect is the levelling down of home securities and the advance of foreign and colonial stocks, a process which seems likely enough to continue, according to present indications. Such was the strength of old-time convention, that even after all that has been said and written—and believed by investors—about the downfall of British industry and the undermining of British credit, many home securities still command a much higher price, and so return a much lower yield, when compared with those of similar investments abroad. The levelling process may at any time be checked by some financial disaster in one of the new countries that our capital is so assiduously feeding; and the eagerness with which they are capitalizing the prospect of their future developments, and mortgaging the achievements yet to come, opens a wide door to the chance of mishap. In such an event, or if a change of Government were to restore the confidence of the investing classes in home securities, there might be a quick reaction, but it may be doubted whether it would last long, for as new countries grow in wealth and population, their

securities, if well and truly based, will naturally and rightly attain to a relatively greater value. In the meantime the growing habit of drawing trust deeds in such a manner as to free the trustees from most, sometimes all, of the restrictions imposed by the Acts, robs trustee securities of one of their surest supports; while, on the other hand, the handsome profits that investors have secured by subscribing for Japanese loans during the war between Japan and Russia, and for Russian loans since more comfortable political relations have been established between the Tzar's Government and ours, have quickened a passion for foreign investments, and opened the eyes of English holders to the conveniences of bearer securities with an international market. Moreover, the great strides in material progress made in the last twenty years by foreign countries and our own colonies give opportunities for world-wide investment that were unknown to a former generation.

When we turn to the causes of the more superficial movements on the sea of markets, we are struck first of all by their tendency to unanimity, or at least to more or less harmony. As distinguished from the great main movement which has marked the history of securities in recent years, by which home stocks fell and foreign stocks rose, the daily and weekly fluctuations in prices show a tendency to be more or less

similar in all markets. That sympathetic thrill which moves markets up or down together is often highly disconcerting to the unpractised speculator, who may, for example, after a careful consideration of the prospects of a Home Railway stock, based on a close study of its traffic returns and its accounts, and perhaps personal knowledge of important developments, such as building areas opening up along the line, take unto himself a modest bull account in it, and then find that though all his calculations and surmises are fully borne out by fact, the price may tumble to pieces, because there is trouble in the Kaffir market, or a break in the price of rubber, or a panic in Wall Street, or friction in the Near East, or a big gold withdrawal from the Bank of England, or some other utterly irrelevant event which seems to him to have no bearing whatever on the merits of the stock that he has chosen. The whole business strikes him as illogical and absurd, and he is apt to wax eloquent on the folly that underlies the movements of securities, and demonstrate that no man of intelligence and knowledge can possibly make money by speculation.

It cannot be denied that the sympathy of markets often has very startling and ludicrous results, and that the explanations sometimes given of market movements are such as to lead one to the conclusion that there is no rhyme or reason at the

back of them. As, for example, when many years ago the reception of a middle-Eastern princelet into the Greek Church made the Kaffir market firm. The connection between arrangements for the ghostly comfort of this royal infant and the profit-earning capacity of the gold mines of Johannesburg is not very obvious at first sight, but what really happened was that this news had some important political significance calculated to please and reassure the Paris Bourse and the French public that operates therein. Being pleased and reassured, the Bourse and public expressed their feelings by buying, and so bought the securities in which they were then most interested, especially in their lighter and more speculative moods. The prospects of the South African mines were just what they had been, but Paris was feeling happier, and so it bought. We have come round again to the psychological question, only to find that when folk are feeling well at ease with the world, and with themselves, they buy whatever they may happen to fancy at the moment, and that if anything gives them cause to feel uncomfortable, their frame of mind is likely to make them doubtful about their bull commitments, and inclined to close them. Hence the apparently absurd, but very real, effect of weather on markets.

But, it will be objected, they buy, even in their moments of most irresponsible bullishness, what

they happen to fancy, and therefore the buying is not merely a matter of hazard; the public does not buy blindly, but makes at least some attempt to select, for its fancy, stocks and shares the prospects of which are attractive. Consequently, any one who has early information concerning the prospects of stocks and shares, or has enough discernment to detect tendencies that will improve their prospects, can anticipate a public demand which may fairly be counted on to follow, and so may rely on making a good profit if he brings real intelligence to bear on speculation. All this is perfectly true, but there are certain modifying facts which make speculation in the strict bull-and-bear sense of the word a very difficult game for members of the ordinary public to play. By the bull-and-bear sense of speculation I mean the kind that is carried out by carrying over in the market, or by pawning stock with a banker. If the operator is in a position to back his opinions by putting down real money of his own, and waiting till he comes right, he has a very much better chance. But then he becomes a speculative investor rather than a speculator, and as such will be considered in a later chapter.

The ordinary bull if he has access to special sources of information—if, for example, he has a friend behind the scenes who can tell him what some big company is going to pay in dividend a

day or two before the news is made public—is then likely enough to make money. Even then he may easily be wrong in his estimate of the effect of the dividend to be declared on the temper of the market, or, again, his shot, though aimed straight enough, may swerve owing to the effect of some irrelevant accident elsewhere. Further, there are some purists who maintain that it is not quite fair to act on this kind of information, since it amounts to something like cheating the man who sells to you, having so much less information behind him. Luckily there is no need to go into this nice question of ethics, because the number of members of the ordinary outside public who have this backstairs knowledge of company affairs is extremely small, so small that we may leave them out of our survey of speculative movements in so far as they affect the ordinary citizen. He, the ordinary citizen, is, as a rule, likely to lose money in speculation, because he is generally behind the fair. The wave movements of securities —the more or less temporary ups and downs of prices which are the subject-matter of speculation —are, as a rule, initiated by professional operators of, or in close touch with, the Stock Exchange. These nimble searchers after profits are in a position to hear good and bad news before it leaks through to the public, and so to skim the cream off markets. By the time that they have bought or sold, as the

case may be, they are ready enough to let public opinion be influenced by noising the event abroad, and this is done by Stock Exchange talk and gossip which soaks through from the dealers to the brokers and from the brokers to their clients, or more directly through communications made to the Press.

For instance, let us suppose that a surprisingly good dividend is declared by a railway company. It is sent by the company to the Secretary of the Share and Loan Department of the Stock Exchange, and by him posted up in the market-place. The dealers promptly raise the quotation, and the speculators of the House take some stock on to their books for the benefit of the public, to whom they propose to sell it at higher prices. Brokers passing the market learn that there has been a jump in the stock on a good dividend, and wire and telephone the fact to clients who may thereby be tempted to deal. At the same time the dividend announcement is sent out to the Press, and City journalists on their rounds in search of news learn of a rise in so-and-so on a good dividend, and chronicle it next morning, or that evening, as the case may be, among the outstanding features of the day's history. So the public comes last. It is the same process, as a rule, if it is a matter not of a definite fact announced, but of anticipations and hints of something good to come

that makes some stock or share—let us call it Options Deep—worth attention. The "tip" goes the round among the quidnuncs, and their buying causes a little movement. "What's on in Options Deep?" is asked by those who like to be well informed, and they are told a repetition or variation of the prevalent story; so the fact or fable, as the case may be, works its way gradually outward to the public, and by the time that the public has got hold of it and acted on it, there are plenty of folk who have forestalled the movement.

There are, of course, exceptional occasions when speculative movements take the contrary course, and are started by the public and later on taken up and fostered by the professionals. Such an one was the rise in rubber shares early in 1910, that financial meteor which was, in many respects, so strange and surprising. More often there are times when the public goes so deeply into a speculation that it gives itself a chance of making profits, one set of buyers handing on shares to another until, perhaps, thousands have done well by the game, and only the later bulls and holders have to rue the day on which they joined in it. In times like these there is money to be made by gambling for differences, as long as the public will continue to come in and buy, and so here we are back again at the purely psychological nature of the problem, and the dependence on markets for

their surface fluctuations on what the speculative public thinks, and for their more lasting movements on what the investing public thinks.

A volatile, excitable public acting in a narrow market will exercise an astonishing effect on prices. The extraordinary upward rush of rubber shares, good, bad and indifferent, that marked the early months of 1910 is a case in point, but, perhaps, the most notable example in history is the rise of thirty points in the French funds in one morning in 1789, when the confidence inspired by the appointment of Necker as Finance Minister made folk think, quite wrongly, as was afterwards proved, that France was going to be solvent and well governed.*

For an example on the other side—of a steady market under the stress of disaster—no recorded instance can approach the conduct of the Romans when Hannibal was encamped at the gate of their city. There was no Stock Exchange to record price movements, and the price of land was then, as in the Middle Ages, the test of public confidence. Hannibal had led his unconquerable host round from Spain and over the Alps, routed and destroyed all Roman armies that had given him battle, and had marched up to the walls of Rome. The piece of land on which he was encamped, happening at that moment to come up for sale,

* Lecky, "England in the Eighteenth Century," vol. vi.

changed hands at a quite normal figure.* With astonishing serenity the Roman public thought that Hannibal was not a factor in the position, and its serenity proved itself right.

Besides the incalculable views of the public concerning the prospects of securities, speculative movements are also dominated by another equally incalculable influence—the supply of money available for the use of operators who want to carry commitments in the market, or to pawn securities with bankers. If bullish enthusiasm becomes so exuberant that it strains the machinery of credit by its demand for accommodation, or if the machinery of credit is being too hard worked by trade demands, or put out of gear by outward movements of gold, or, still worse, if it is jarred by apprehensions that there is something wrong with itself, then bull commitments will have to be closed, and prices will have to go to pieces, however optimistic may be the views current concerning them. There, again, the ordinary citizen is nearly always at a disadvantage as compared with the professional speculator, since he is not nearly so careful as the latter to watch the signs of monetary weather, and arrange his commitments accordingly. It is very difficult for the unsophisticated outsider to understand all the intricacies of the money market, or to grasp the fact that trade may sometimes

* "Nihil ob id deminuto pretio."—LIVY, xxvi. 11.

be so active and prosperity so general and imperative in its demands for credit and currency, that the stock markets are actually pinched by lack of cash, and so have to droop and dwindle because their gambling supporters are obliged to moderate their enthusiasm just at a time when there seems to be most reason for it. With paradoxes of this kind in his path, and with all news coming through to him at second or third hand, there is little wonder that the speculator who is not especially gifted or informed generally loses more than he makes. But hope springs eternal in his human breast, and he sometimes learns something from his speculations How many of us knew two years ago that rubber was got by tapping a tree?

NOTE.—The above chapter refers only to the conditions of the London market. I believe that in Paris the public is guided very largely by the advice of the great French banks, whose opinion, consequently, is an all-important influence on price movements. In New York, it is alleged that certain controlling groups have an enormous power over the market, owing to their vast holding of securities and their control of credit facilities.

CHAPTER XI

THE REAL INVESTOR

Contemplation of securities and their movements brings with it a sense of vagueness and fluidity, and makes one marvel at the confidence of those who tell one that such and such a stock is bound to go up or is much too dear. From our examination of company accounts and balance-sheets we saw how difficult it is to know whether the profit claimed as earned can be taken as well and truly got, or whether it has been made to look as if it had been gained by neglect of the just claims of depreciation, or by providing out of capital account for current needs which ought to have been met out of revenue. In the other great branch of securities, those provided by the debts of Governments and municipalities, we have seen that they are ultimately based on the capacity of the community for paying taxes, and its willingness to make sacrifices, if necessary, to keep its collective good name as an honest payer of its debts; and, further, that they, more especially Government

loans, are liable to be affected in a surprising manner by political influences—war and the fear of war. Looking at this quaking morass of uncertainties and assumptions, balance-sheets with assets making no pretence to represent realizable value, Governments piling up debts and leaving posterity to meet the bill, the investor may well wonder what he is to do with his money, and whether it is not best, after all, since all is so vague and shifting, to choose the securities that give him the biggest yield and leave the rest to luck.

These counsels of sceptical despair are wholesome enough up to a point, but it is a great mistake to carry them too far, or to let them drive one into recklessness. They should rather be used as a weapon to sharpen the investing intellect, and make it recognize that since it is impossible to eliminate risk and chance altogether, there is all the more reason for using as much care as possible to protect oneself against them. In the matter of Government stocks it is possible to distinguish the loans of nations which are using the capital that they borrow for reproductive purposes and the development of their estates, from the loans of those which are drawing bills on the future in order to meet current deficits. The natural resources of the country, the growth of its population, and the development of its home and foreign trade are all factors in the problem, and the extent

buys with a view to getting an assured income on his money with as little risk as possible attached. Some risk is attached to almost all securities dealt in on the Stock Exchange, because even though the interest may be, for all practical purposes, secure, there is almost always the chance that if the holder were forced to sell, he might not get so good a price as he paid. It is possible to avoid even this risk by only buying securities which are bound to be redeemed in two or three years' time, and so are practically secure against a fall, but this process involves the constant trouble of re-investing, and it is often difficult to find enough of this kind of security. No investor, of course, is wholly indifferent to the prices of the stocks and shares that he holds. He may cultivate enough philosophical serenity to know that as long as his income is safe the prices at which his securities stand are not a matter of practical moment to him, unless he should happen to be forced to sell—and, after all, why should he be forced to sell?—but even so he will always feel more comfortable if his purchases have been followed by some improvement in the value of his stock, and when buying he naturally hopes that this will follow. To this extent every investor is a speculator, and the difference between the two classes is finally, like most other differences, one of degree. All that we can say is that the real investor looks most of all to security of income and

least to the hope of capital appreciation, while the pure speculator sets no store by income, and looks entirely to the chance of being able to make a big profit by a resale, and that between these two extremes there is a long chain of gradations from speculative investors down to investing speculators, varying according to the extent to which they put income or capital profit first in their affections. Those who have to buy securities will save themselves and their professional advisers some trouble if they commune with themselves for a few minutes, and make up their minds definitely as to which class they mean to join; whether they really want income and security, or are in search of a scheme for increasing their capital by speculation.

To those who range themselves definitely among the pure investors the problem is comparatively simple. There are two well-known saws on the subject of investment. First, "The higher the yield, the lower the security," and second, "Never put all your eggs in one basket." On these two themes variations are constantly played with infinite ingenuity by all who write and talk about investment, and, especially with regard to number two, the expert advisers of the public are fertile in schemes for scientific distribution of risks by climate, or by geography, or by industries, etc., etc. Neither of these two hoary truisms, however, is

quite sound, and the first is especially misleading. Legal enactment occasionally gives securities a special advantage which raises their price, and so depresses the yield on them in a manner which intrinsic merit does not justify. For instance, the law which made United States Government bonds the basis of note circulation in America, compelled any bank there which wanted to issue notes to get United States bonds, and made it pay a price for them which was enhanced by the profit that it expected to make out of its note issue. Consequently, the American banks could afford to pay prices for these special securities which would have been out of the question for any stock that had to be valued according to its mere yield to an investor. United States two per cent. bonds rose at one time to well over par, thus returning less than two per cent. to the buyer; but any one who therefore inferred that United States bonds must be a much sounder investment than British Consols would have been wrong. Our own Trustees Acts have had a similar effect. By restricting the powers of trustees to certain classes of securities, they have ensured that all stocks which come within the charmed circle should be constantly supported by the competition of those who are responsible for estates in trust. Although trust deeds are nowadays often specially drawn, so as to enable the trustees to go outside the limit which is legally

imposed in the absence of provision to the contrary, there is still the result that an enormous amount of money annually has to be put into stocks that are within the legal ring-fence. Among them are several which would hardly be ranked on their present exalted level if it had not been for the special advantage given them by the law.

Besides the law there is the effect of convention and fashion, influences which are strong among the classes from which investors are chiefly drawn. Convention marks a stock as good, and the public thinks that it is so and keeps the price up, as in the case of Home Railway stocks, which are much lower than they were, but still carry a certain prestige which has an effect on their price. Then there is the good old economic law of supply and demand. However sound a stock, or a group of stocks, may be, if there is a continuous supply of it, or them, the sellers will have to take less. In this year, 1910, American finance has got itself into an uncomfortable position because of the remarkable reduction in the ratio between the exports and imports of the country. Being a debtor nation, and, consequently, having large payments to make abroad for interest on borrowed capital, America has annually to export a big balance of goods in order to pay her way. This balance has shrunk during the last two years in an extraordinary manner, owing to the increasing

consumption of her products by her own citizens, and at the same time American indebtedness to foreign countries has probably grown, and the amount of the expenditure of her rich citizens on foreign travel and foreign luxuries has certainly grown, and all this has to be paid for ultimately by the export of goods, or something, from the United States. America has been meeting the problem partly by sending gold to London, but still more by selling the bonds of her great railroads. Thereby, it may be observed, she makes the future problem all the worse, because in future all the bonds that she has lately been selling will cause an annual drain to pay the interest on them, which will have to be remitted in goods or gold, or more and more securities. The point that immediately concerns us is the fact that this necessity, which compels America to sell us securities, depresses the prices of her railroad bonds, and so raises the rate of interest that a buyer can get by investing in them, and once more disproves the old truism which says that the higher the yield the worse the security must be. The security of the first-class American railroad bonds is not a pennyworth worse than it was, but circumstances have caused them to be thrown on the market in increasing quantities, and so they have had to fetch a lower price, and return a higher yield to the buyer.

As for the other old saw about never putting all

one's eggs into one basket, much depends on the basket and who is carrying it. The better the security, and the less the owner need mind about the price at which it may happen to stand, the less need there is for him to pay any attention to this adage. Any one who can live comfortably on £800 a year, and has got £40,000 Consols bringing him an income of £1000, is beyond the reach of the "slings and arrows of outrageous fortune," and need never care about the price at which his stock may happen to stand. His income is assured as well as any income can be, and if his stock falls in price he may console himself by remembering that his executors will have all the less estate duty to pay. But nowadays there are not many people who think that they can afford to put their all into Consols and live on it. High taxation and unthrifty living drive most of them into something not quite so safe, but safe enough, as they hope, and they rush into Japanese loans or American railroad bonds, or whithersoever the prevalent fashion may drive them, and try to be scientific in the matter of choice and distribution. This being so, let us consider what any one who buys a security for the purpose of pure investment ought to be justified in claiming from it under present conditions.

The test of a real investment is the question whether it can, or cannot, be recommended for

the purposes of the widow, the orphan, the maiden lady or the retired officer, who has to live on a small income derived from investments, and has no personal earning power to fall back on if anything goes wrong with this income. For such as these, the security cannot be too ample, and at the same time income is very important. This is the kind of investor that puts the good broker on his mettle, and he will take a real interest in finding them stocks that are safe and yet carry a fair yield. Such a broker proposed to amend the old saw about "The higher the yield the lower the security," into "The higher the yield the better the broker," and there is no doubt that investors who are well and skilfully advised can often enough find stocks with an ample margin of revenue and security behind them which yet yield higher rates to the buyer than many which are less solidly based, but have some conventional or other prestige which hall-marks them as respectable, and makes them dear. It is above all things essential that the investor, or rather his broker, should approach all securities with a healthy scepticism, refusing to believe that any stock is good and sound because it stands high and is generally looked on as good. He has to look into the facts of every case, take nothing for granted, and accept nothing as true because it is a commonplace.

It has been shown in previous chapters that

among the securities of railway and industrial companies, the bonds, debentures, and debenture stocks stand first. If the terms of their trust deed —which is always examined by a careful broker before he will buy a bond or debenture stock—are as they should be, the trustees for the holders can foreclose, that is, seize the property, or certain specified parts of it, if the interest is not forthcoming at the due dates. They have the first charge on the income of the company, the first lien on its property and assets, and their holders are in the position of creditors who have to be repaid at a date. Some of them are perpetual or irredeemable, but these are unusual and undesirable. Any one who holds a bond or debenture, or a bit of debenture stock, which is sufficiently covered in the matter of income and property behind it, which carries foreclosure rights, and has to be redeemed by the action of a sinking fund, has got a real investment. The sinking fund is a sum set apart every year, out of revenue, for the redemption of debt; it may be applied either by purchases of stock in the market or by periodical drawings—by which bonds and debentures are chosen by lot to be paid off at a stated price—or it may be used to pay a premium to an insurance company which pledges itself to meet the capital of the debt at the final date, or to buy other securities to be realized when the debenture falls

due; but however it works it gives steadiness to the price, and safety to the holder, of the stock, which no perpetual or irredeemable security can show.

It will be objected that the phrase "sufficiently covered in the matter of income and property" is vague and indefinite, and I am well aware that this is so. The pedantic mind naturally craves for a precise formula, and my craving was so strong that I drew one up, laying down that in the case of an industrial security the income should be covered so many times over, and that it should be represented by real tangible assets in the balance-sheet —cash, securities, debtors, and freehold and leasehold property and buildings—valued at a sum which should be at least a certain multiple of the amount of the debenture. But second thoughts put the formula into the waste-paper basket. The margin of income and of assets must vary in every case with the circumstances of the industry, and any attempt to lay down a hard-and-fast law must be so pelted with exceptions that it would be smothered under the heap. Vagueness on this subject is really more business-like and satisfactory than the comfortable air of completeness that a formula carries with it.

A well-covered preference stock or share, if it be well enough covered, is almost as good as a debenture, but there is the very important difference

that in this case there is no question of repayment, and that the holders are a specially privileged class of proprietors of the company which issues the preference security, and are not creditors who may, or may not, be paid off. It is true that if the ordinary shareholders decided to put the company into liquidation the preference holders would in most cases only be entitled to the face value of their shares or stock, and in these circumstances any one who had paid 120 or so for a well-secured preference stock would suffer considerable loss, having his holding returned to him on the basis of par, or £100, for each £100 of stock. But this is hardly a question of practical politics. Prosperous and well-financed enterprises do not liquidate themselves merely for the pleasure of defrauding their preference holders. Liquidation is sometimes threatened in order to induce preference holders to submit to an infringement of their rights, or a payment of their arrears in paper, when a company is reconstructing owing to misfortune or mismanagement; but this sort of experience is not likely to face the real investor who buys chiefly for security and a steady income, and safeguards himself by adhering to austere ideals. At the same time, the fact that the holding of a preference stock or share only entitles the holder to the return of the face value, as a rule, in case of liquidation is an argument against paying big prices for this

kind of security; it is better to buy a good 4 per cent. preference at 98 than an equally good 6 per cent. preference at 147; the income on capital invested would be in both cases the same; but if the company were wound up, and the preference holders had their capital returned at its face value, there would be in one case a small profit and in the other a very big loss.

The absence of a redemption date and a sinking fund at work to meet it, deprives preference securities of the important support which increases the solidity of good debentures and debenture stocks; and it follows that those who invest in them must be especially exacting in their demands for an adequate margin of income and of real assets behind the stock. It is also a great improvement to a preference security that it should be cumulative, that is, that if its dividend should fall into arrear, all arrears should be paid off before ordinary shareholders receive any distribution; and it should have preferential rights as to capital, so that if misfortune drives the company into liquidation, the preference holders should have their capital paid back in full before any return is made to ordinary holders.

As for ordinary stocks and shares, there are some few that are so solid and depend so little for their dividends on the momentary prosperity of the companies that issue them that they may be

regarded as real investments. But they are hard to find and, generally, still harder to buy. If anything goes wrong the ordinary holder first feels the pinch, and however well advised a purchase may seem to be at the time when it is made, unforeseen circumstances may always arise which show that it is the safest rule for investors who hold ordinary securities to look upon them as a concession to the gambling spirit which is strong in nearly all of us, and to regard them as the speculative sauce which seasons the investment salad. But whether the investor holds debentures or preference or ordinary stocks, it is very necessary that they should be periodically overhauled and examined in the light of the latest information available, and thrown out ruthlessly if they show signs of deterioration.

The kind of investor whose wants we are now considering cannot be too particular and punctilious about the security of the stocks that he holds. The security for the obligations of a company lies in its earning power and assets, the security for the obligation of a nation or municipality lies in the taxable capacity of the community, the revenue-earning power of its reproductive assets, if any, its readiness to make sacrifices, if necessary, in order to pay its debts, and its collective character with regard to vigour and material expansiveness.

Let us take the case of company stocks and shares first. We have seen plenty of cause for being very sceptical about their earning power and assets, because it is always impossible to be sure that the balance taken credit for as net profit has been arrived at after making full and true allowance for depreciation and upkeep, and for possible variation in the price at which stock-in-trade—or whatever the elusive items of finished or half-finished work is called — may ultimately be realized. One or two people behind the scenes know these things. You and I have to take the published statements on trust, and on our faith in the integrity and good intentions of the Board. We have to remember that even the most upright and well-intentioned Boards are liable to error, and cannot be expected to be expert valuers of all the property that the company may hold, also that the uncertainty which we saw reflected even in Mr. Pixley's pronouncements concerning the nature of a balance-sheet, and the treatment of the items on the credit side, makes it doubtful whether a balance-sheet is supposed to show the value of a company's possessions, or the sums that it has spent on them. When high auditing authority flouts the view, that the balance-sheet ought to show on the credit side the saleable or market value of the items there enumerated, it is no wonder that the average director of an industrial company should

follow this lead. In fact, as long as a company can maintain itself as a going concern, most Boards generally believe that they are entitled to treat any balance that its books show it to possess, in cash or on paper, as divisible profit. Well-financed companies put something to reserve rather as a matter of grace, except banks and insurance companies, which live on their credit, and so have to treat reserves really handsomely; ill-financed ones not only do not do that, but sometimes do not even maintain themselves as going concerns out of revenue, but draw on capital account, constantly fed by fresh issues in order to do so, and so lay up trouble for the future, as Home Railway shareholders have in recent years been discovering to their cost. Consequently, when some new factor, like electric tramway competition or motor traction in the case of a railway, comes within the bounds of practical politics, there is no available margin with which to fight it, and the ill-financed company is helpless before its attack.

Being, therefore, sceptical concerning the nature of company profits and assets, the real investor who wants a security which is not going to shiver before the first breath of adversity that may affect the company of which it forms an obligation, will insist on a very big margin of revenue behind any stock or share that he buys. The margin, in fact,

must be so big that the ordinary fluctuations of earnings due to seasonal or cyclical variations of trade activity shall not have any appreciable effect on the price of the stock. Though we have admitted that the assets on a balance-sheet are a very weak reed to lean on, we may at least allow some negative importance to them, by refusing to look at a security which is not represented by assets which may have a sporting chance of being realized, namely, cash and securities (quoted and of a kind that an auditor can test), sundry debtors in so far as they exceed sundry creditors and other forms of floating debt, freehold and leasehold property or buildings, and track and stations in the case of a railway. Machinery and plant, tools and stock-in-trade we leave out as problematical, goodwill and patents, preliminary expenses, and advertising we ignore as fanciful, but if other and more solid items cover our security with an ample margin we may feel a certain amount of contentment. It must be remembered, of course, that if our security is not a first charge, we have to allow for the securing of its predecessors before looking into what is behind it. Every individual case has to be judged on its own merits, but by applying the test of net revenue and tangible assets, we at least avoid the fatuity of the Trustees Acts, which, in the case of the companies which they included

in their permission, applied only the test of dividend payments, without any regard to the question whether the dividends paid had been earned.

Other considerations which have to be applied to companies in which a real investor proposes to become interested are size, the nature of its business, and its liability to political or other disturbances. As to size, it is evident that the smaller the company is the more strictly we must apply our tests. In the first place, in a small company the securities will be small in amount, and, consequently, more difficult to buy or sell, and in the second, though some small businesses may be exceedingly sound and safe, as a general rule it may be said that the bigger the turnover and the wider the circle of customers, the less likely the enterprise is to be affected by the attack of a new competitor or a change in the habits of the community which may modify the demand for its product. For example, if we contrast the position of one of the great trunk railway companies with that of a little Welsh mineral line, we see at once that one is kept busy by all kinds of goods traffic—agricultural, industrial, and commercial—and by a stream of passengers on business and on pleasure bent, so that its earnings may vary, but are fed by so many springs that they cannot dry up; while in the other case a strike or a trade dislocation may, for the time being, wipe net revenue out altogether.

Steadiness of demand for the commodity or service produced is another very important question. Securities, however abundantly covered, issued by a company which owns a rink or an electric theatre would naturally be regarded with suspicion by a careful investor, since this class of entertainment depends on the shifty gusts of popular fashion, and is liable at any time to be ousted by a craving for ping-pong, or a revival of the Punch and Judy show as the first and last word on dramatic sincerity. Sour milk may go the way of the black draughts of the mid-Victorian period, and it is possible that even millinery may languish under the efforts of the No Hat crusade. What men must have are food, water, shelter, clothes, light, heat, and transport. But in all these desires there is wide scope for variation of demand except in water, and the supply of it is now largely in the hands of public bodies. Caterers for the domestic food supply may be hit by the uncomfortable modern practice of dining at hotels, houses may be forsaken for flats, clothes vary with every breath of fashion, the profits of the coal trade are subject to enormous fluctuations owing to changes in the weather and the shifting demands of industry, and changes in the means of transport have knocked a great hole in the monopoly of the railways. Lastly it is desirable to note that the country or countries in which the company works and sells should be more or less

settled communities not liable to wild political upheavals. Holders of certain South American Railway stocks are sometimes disturbed by the publication of very unfavourable traffic returns with a footnote explaining that the line is "in the hands of the insurgents," and those interested in the petroleum companies of Baku have seen their security impaired by an outburst of anarchy in which murder became a daily incident, and industry of all kinds was almost brought to a standstill. Finally, we have to be especially insistent on a big margin of income and assets when we invest in any form of agricultural enterprise, and thus make ourselves the plaything of the weather, with frost and heat, drought and flood, pests and blight arrayed against us.

Summing up our claims on company securities from the point of view of the real investor, we suggest that he should insist on a stock that is definitely repayable at a date, its interest covered several times over by revenue, its capital covered with an ample margin by genuine and solid assets, a big stock in a big company, producing a commodity or service of steady and wide consumption, working and selling in settled countries not liable to political upheaval, and that he should not fail to demand specially stringent safeguards if he ventures into stocks that are affected by weather and other freaks of nature.

When he turns to Government and municipal securities, the investor's problem is simplified by the absence of data. No one can say what is the taxable capacity of England, or of any other country, and no one can say how far the citizens of any country will go in allowing themselves to be individually mulcted for the sake of their common credit. In the case of debts devoted to reproductive expenditure, it is as difficult to know whether the expenditure is really productive—that is, whether the railway or the tobacco monopoly, or whatever it may be, really pays—as it is to know whether the alleged profits of a joint stock company have been well and truly earned. We can only know that debt so expended is better—from the point of view of the borrowing community, if not from that of those who travel on the railways and try to smoke the tobacco—than debt which has been incurred to cover revenue deficits, or to pay for wars or mobilizations or navy-building competitions. The investor can only grope his way among the psychological problems involved by the collective debt of a community and the chances of its being met. He may at least insist that any loan of which he buys part should be definitely redeemable, and provided with a sinking fund which shall duly carry out its repayment. He may also reasonably prefer to avoid the loans of those countries, even though they be the richest

and apparently most prosperous, which habitually outrun the constable, and even in times of peace spend more than they get in revenue, and so continually pile up debt which is represented by nothing but improvidence and slackness, or a deliberate pampering of the present generation at the expense of posterity. If he also avoids the debts of countries which are subject to internal commotion, and are likely to be involved in international friction, he will find that these limitations have narrowed his choice in a manner which has simplified his problem almost out of sight.

It may be objected that the tests applied to Government loans would, if strictly enforced, rule out Consols: in their case the only right that the holder possesses is the right to the receipt of a certain income; they are not perpetual, for in 1888 holders had the choice held at their heads of conversion or repayment, nor are they redeemable at a stated date, nor have they a special sinking fund that must be applied to their redemption. All this is true and helps to account for the fact that Consols are in many respects a very undesirable stock, and capable of astonishing fluctuation. Nevertheless, they have the imposing security behind them that is given by the taxable capacity of Great Britain, and though the sinking fund may be occasionally directed to other forms of the British debt, the fact remains that on the whole we do steadily reduce

the amount of Consols in times of peace, and that we do, as a rule, raise more in revenue than we spend.

It is also true that many of the richest nations are most reckless in the matter of spendthrift finance merely because the wealth of their citizens is so great that they can afford to be reckless. France, for example, continually adds deficit to deficit, and yet its people are so thrifty that he would be a bold critic who would deny first-rate security to French Rentes. The wealth of the owing community is certainly the chief question to be considered in looking into the debt of a Government or municipality, but this wealth is a factor that can only be guessed at, and however rich a State or town may be, it cannot afford to ignore for an indefinite period the counsels of prudent finance, and the fact that a debt which is not represented by a productive asset is a millstone round its neck. The debtor may be so strong that it does not feel the millstone, but the weight of it is there, ready to press with its deadening effect as soon as any adversity or sudden strain weakens its bearer.

CHAPTER XII

THE SPECULATIVE INVESTOR

THERE are very few real investors. In fact, one is almost inclined to echo the "memorable and tremendous" words uttered by Betsy Prig—"I don't believe there's no sich a person." Nearly every one who saves, inherits, or otherwise acquires money wants to put it into something that will give him an income and increase his capital, and so is at once an investor and a speculator. Any one who has real money of his own to deal with in this way may sometimes add to it by judicious selection of improving securities. The pure speculator who cannot or does not back his fancy with his own money, but works with borrowed funds, and so cannot afford to wait long before his expected profit is harvested, is more likely to lose than to gain by speculating; because the temporary fluctuations that he has to depend on for his gambles are generally foreseen and acted on by a nimble host of specially informed insiders before any members of the ordinary public have

become alive to their likelihood. The speculative investor is in a different position. Having money to put down, he can wait; and so he can go searching for bargains in the byways of markets, taking stocks of which the intrinsic merits have not been recognized by the concensus of investing opinion which is required to raise their prices, and biding his time quietly until this happens, when he sells and looks round for another opportunity. Knowing the habit of his investing brethren to run in grooves, and to be ruled by convention and fashion in their choice of securities, he can sometimes increase his capital by merely cultivating a certain eccentricity, giving his attention to those classes of stocks which are at present out of favour, and waiting until a turn of fashion's wheel brings them back into the sunshine. If any great disaster overtakes a market, such as the effect of a panic in America on American railroad shares, or of a drought on Australian land companies, he will know in the first place that the good securities will tumble down with the bad ones, though perhaps not quite so much, and in the second that the influence of the event on the mind of the general investing body is likely to be prolonged and exaggerated. Consequently, he can reckon on a hunting ground in which he is likely to be for some time undisturbed, able to pick up stocks which are under a cloud which has affected, not

their earning power or security, but what the public thinks about them. The speculator with borrowed money has to buy stocks that the speculating or investing public is going to fancy to-morrow, or within a few weeks, if he is to make money by his operations. He has to adopt Mr. Pickwick's great political principle, and shout with the largest mob—if possible, before the mob begins to shout. The investing speculator can follow the much easier course of buying good securities which the investing public is at present neglecting, knowing that some day or other it will come back to them, and in the meantime earning a good round yield on his money by buying stocks which are discredited for some quite irrelevant reason.

It has been shown in earlier chapters that market prices are subject to very many influences besides those which make the stocks that they represent really more or less valuable. The essence of the speculative investor's problem lies in the power to distinguish between movements in stocks which are due to some influence which has made a real difference to their security, and those which are caused by external circumstances and have nothing to do with the merits of the stock. Let us take a concrete example or two, and trace out the influences that may move a security up or down, and distinguish those which have really affected its merits from those which are due to

outside influences. In order to cover the range of the operator's choice let us take Consols and then a rubber share.

Consols represent the collective capacity of the inhabitants of the United Kingdom to pay their way and meet the service of their debt. If we can detect any symptom of a diminution in this capacity we shall have found a real reason why Consols should be lower. The taxable capacity of any community can only be guessed at, but probably even the most pessimistic spirits among us will acknowledge that such figures as can be got indicate growing national wealth and growing activity in our home and foreign trade, subject to the cyclical fluctuations which puzzle economic inquirers and sometimes make them talk about sun-spots. At the same time, though the capacity of the community for paying increases, the demands upon it for payment increase likewise. Every department of public activity clamours continually for more money, and this increasing expenditure makes it all the more difficult for Chancellors of the Exchequer to maintain the Sinking Fund, which is devoted to the redemption of British debt, of which Consols are the most important item. Since the gradual reduction of the amount of Consols by the action of the Sinking Fund has been a very important support to their price, it follows that if raids on the Sinking Fund continue

Consols will tend to fall. Apart from this, increasing expenditure, if well spent on good objects, ought not to have a directly bad effect on Consols. Impregnable strength in our land and sea forces through wise expenditure on army and navy, and a cleaner, cleverer, healthier, and more productive population, through wise expenditure on education, social improvements, agricultural development, and labour organization, should improve our security and increase our taxable capacity. But there is too much reason to believe that expenditure is by no means always wise, that there is great waste, and that the greater the sums spent by the nation the greater the proportion of waste becomes; and indirectly, growing expenditure tends to make Consols lower. If it be met by higher taxation, the investing classes are all the more strongly impelled to seek securities with a higher yield, and so Consols are left more and more out of fashion. If it be met by borrowing, as seems only too likely in these days of spendthrift finance, either the amount of Consols is increased to the detriment of their price, or fresh competitors with the same security behind them are created, again to the detriment of their price.

Further, the intrinsic merit of all securities is relative—in other words, all securities compete more or less with one another. Consols are in some respects a fancy article, as necessary as office

furniture to banks and other institutions which have to hold a certain amount of a stock that can be sold or pledged with the utmost readiness, but the extent of this special demand for them is limited, and ultimately they have to compete with the rest for the favour of the investor. If the progress of the world's work requires a constant creation of new securities, more rapid than the growth of the power of the international investing community to absorb them, the intrinsic merit of Consols will be modified, in so far as the new securities created are sufficiently well secured to compete with them seriously. Here, again, we are in the region of guess work, but it seems rather likely that commercial expansion all over the world will for the present be as rapid as the growth of capital will permit, and that, consequently, a constant stream of new securities of all kinds may be expected to compete with those already in existence, and so to impair the relative merit of Consols. Whether the prestige of a stock, and the favour with which it is regarded by the investing public, can be rightly included in the items which make up its intrinsic merit is an open question, but I am inclined to think that at least in the case of Consols prestige may be so included. The prestige of Consols has been much reduced in recent years by causes which have already been detailed, but on the other hand, now that the price has come down

to a point at which they yield a full 3 per cent. to the buyer, they are made attractive to a new class of holders, and might easily be made popular with small investors if more convenient arrangements were made for their transfer, and, still more, if more facilities were given for their purchase and sale in small amounts through the Post Office. Finally, the price of Consols is also to some extent an expression of the national state of mind. The national state of mind is at present decidedly diffident. The politicians most trusted by the investing classes tell us that we are going down-hill, and our most optimistic leaders can only say that they hope that we are not really so very decadent after all. If this diffidence is too successfully fostered, it cannot fail to impair our national virility and vigour, and produce the decadence that is alleged, and ultimately react on our taxable capacity; but perhaps we shall shake off this nightmare and see ourselves once more, in Milton's splendid phrase, "a noble and puissant nation, rousing herself like a strong man after sleep, and shaking her invincible locks."

In the meantime, having considered the causes and influences which affect the intrinsic merit and so the price of Consols, let us consider a few of the factors which warp the natural course of their movements, by raising or depressing them without any regard to their real security. Chief among

these are the state of international politics and the condition of the international money market. Any news or rumours that make folk think that foreign war is likely will tend to make Consols flat. For example, diplomatic friction between Germany and Russia would undoubtedly affect the Consols market, though it need hardly be said that the intrinsic security of Consols would not be in any way impaired. The hint of war makes everybody apprehensive and uncomfortable, and is likely to produce an immediate restriction of credit facilities. Nobody feels quite sure where war will end if it begins, and when war is in the air there is a general desire among the financial and commercial classes to take in sail, clear away top-hamper, and make themselves snug against possible squalls. The very practical effect of this state of mind is that sellers who would yesterday have taken a promise to pay quite cheerfully against delivery of goods, begin suddenly to think that there is much to be said for cash, and there is a general disposition to realize securities. Consols, being still among the most readily saleable of all securities, and being kept by many firms and companies merely because of that merit, are the first to come to market, and so are, in fact, sold first because they are in this respect the best. Moreover, many professional speculators who have big commitments for the rise in less saleable stocks, and do not wish to

spoil their own market in them by trying to realize them at a time of nervousness and hesitation, will probably try to hedge their position by selling a bear of Consols, and the immediate effect of these sales will be as effective as that of real stock coming to market, though when carry-over day comes round, and it is found that many operators are short of stock, the discovery of the existence of a bear account will tend to steady the price. Further, the danger of war affects Consols through the fear of a change in the international monetary position, for war always means a demand for ready money owing to the actual cash payments that have to be made by the combatants, the dislocation of trade that ties up credit in one place and demands the creation of credit in another, and the unwillingness of all dealers in money to part with their commodity at a time when it seems likely to command a higher rate. A rise in the value of money tends to lower the prices of all securities, for if bankers are paying 4 per cent. to depositors, there is less temptation to put money into stocks than when bankers are only paying depositors 2 per cent., and the fall in securities caused by higher rates for money is most rapid and acute in the case of those which are best secured, because in their case their price is influenced most by the actual return to be got from them, and least by possibilities and speculative fancies; and so,

once more, Consols will come to market most quickly because of their intrinsic merit.

This depression of Consols through fear of a change in the state of the international money market owing to war, will also be brought about if money becomes dear for any other reason, for example, owing to great activity of trade and high prices of commodities. When all the world is busy producing and exchanging goods at a high level of prices, the demand for money for trade purposes in the industrial centres becomes so great that the credit facilities given to finance are likely to be curtailed, and so finance—that is to say, the City—has to sell its most marketable securities in order to provide funds for financing others which it is nursing and cannot so easily dispose of. Thus Consols are likely to be depressed by a chain of circumstances which spell great commercial activity and national prosperity, and are, in fact, in favour of their intrinsic merit, since they tend to increase the taxable capacity of Great Britain. All these paradoxes and topsy-turvynesses are the opportunity of the speculative investor, who tries to increase his capital by buying stocks which are depressed by external causes, but have not been impaired with respect to their intrinsic merit. For external causes are fleeting in their effect, and intrinsic merit, as long as it is recognized by a large enough number of the investing public, will

ultimately tell. Hence the speculative investor who can put money of his own into a stock that is low owing to reasons which have no connection with its real merits is likely, in a fair number of cases, to increase his capital if he has patience enough to see the game through to the last trick.

Now let us consider the case of a rubber share. The intrinsic merit of a rubber company depends on its ability to produce with little expense a large quantity of rubber and to sell it at a high price, and so to pay big dividends. The chief items in its requirements, as far as it is itself concerned, are a good estate, good management, plentiful and efficient labour, and a relatively small capital. If two companies earn £50,000 a year by the sale of their rubber, and one has £100,000 of capital and the other £50,000, arithmetic decides that one can pay 50 per cent. in dividend and the second 100 per cent. Apart from all that the rubber company can do in judicious growth and tapping and economical handling of its product, the size of its profits will depend to a very great extent on the price current for rubber, which is thus an ingredient in the intrinsic merit of the shares of the producer. There are also a hundred and one accidents quite external to the fortunes of the company which may affect the price of its shares. In the first place, much will depend on the quality of the holders, whether they are investors interested in

the industry and meaning to hold their shares as a more or less permanent investment, or hunters after quick profits who will sell as soon as the price has risen high enough to meet their ambitions, or as soon as the least possibility of a reaction makes them hurry to clear out before it is too late. This consideration applies not only to any particular share, but to the state of the market as a whole. If it is in the nervous and hysterical state that arises when the support of a market is chiefly speculative, and prices rise and fall with neurotic jerks and tumbles because every one is in a fearful hurry to be in or out, the movements of the best shares will be very nearly as erratic as those of the worst, because of the sympathy which always exists between the securities handled in the same market, and arises chiefly out of the human element that is so bafflingly predominant in prices. Again, if it were so to happen that some of the companies which have lately been brought out since the wild excitement began in the rubber market were to prove to have been hopelessly over-capitalized, and to have been formed to acquire and develop a noisome swamp where no self-respecting rubber tree could ever be induced to grow, the consequent discredit to the industry would almost inevitably affect the good companies as well as the bad. Actually this discovery would be in favour of the good companies, because it

would mean that less rubber would be produced, and the market in the commodity would thereby be all the harder; but it is fairly safe to expect that the first undiscriminating impulse of the many-headed would lead it to the hasty conclusion that all rubber companies were swindles and impel it to throw out its shares. Still more probable, and much more logical, would be a general depression in the market if it were found that any of the plantation companies were suffering severely from disease among their trees or any of the other natural afflictions that cultivation is heir to. Blight, fungus, disease, ants, storms and floods—these are the spectres that haunt the dreams of the uneasy holder of rubber shares who is not sure whether he has not got rather too many, and whether he is not venturing too much of his capital in an alluring but venturesome gamble. The appearance of any of them on a scale sufficient to make a serious difference to production would almost certainly cause a very uncomfortable tumble not only in the shares of the companies really affected, but also in those of concerns perhaps half a hemisphere removed from the seat of the trouble, and quite free from any threat of danger.

Further, as has been seen in a former chapter, an uneasy feeling in any of the speculative markets is almost certain to communicate itself to the others, since operators who grow nervous about

any of their commitments are likely to feel uncomfortable about all of them, and the nervous feeling is exceedingly infectious in the crowd of highly strung and often overworked dealers who form the chief population of the Stock Exchange, and is passed on by them to the brokers, and so to the public. If there is a vulnerable bull account in Americans, and the Supreme Court gives a judgment, or the President makes a speech, which jars on the nerves of Wall Street, it is quite possible that the shares of plantation rubber companies may be affected by the consequent weakness of the American market. Finally, it need not be said that the price of any stock, or the general course of any market, is liable at any time to be affected by the mere question of the number of people who are bulls, a matter which has little to do with the intrinsic merit of the security, but often has a potent, though temporary, influence on prices.

These external causes which warp the course of market movements, but have no real connection with the ultimate value of stocks and shares, are a source of discomfiture to the speculator on borrowed money who has come out to seek a quick profit and sees his calculations upset by them, but are the opportunity of the speculative investor. The bull has to snatch a profit by anticipating a demand for a security; the demand

must follow shortly, or his commissions and contango charges will eat up his gains. The speculative investor has the much easier task, not of trying to forecast the movements of securities, but of taking advantage of them when they happen. When he sees that the price of a stock is low owing to reasons which have nothing to do with its real merit, and are not likely to last, he can take home a parcel of it with the reasonable expectation that the logic of fact will sooner or later make the price of the stock return to a closer connection with its security and yield.

It is a reasonable expectation, but by no means a certainty, for some subtle change in public opinion may always come in to defeat it. The speculative investor's chance of making money is a better one than that of the bull who depends on other people's capital, and has to pay for the use of it, but his operations require the exercise of much care and skill. If he confines them to stocks which are fairly solid and yield him a good return on his money he is not likely to lose much, but on the other hand the fluctuations in these securities are usually less violent and so give him less chance of a big haul. Perhaps, on the whole, operators of this class make more than they lose, but whether their gains compensate them for the time and trouble expended and the

risks run is a very open question. The knowledge and judgment required for the business are rarely at the disposal of the ordinary citizen, and for success in this game of bargain hunting the advice of a really good and careful broker is a first necessity.

An operation which is commonly called stagging is another speculative method which is dangerous to the impecunious gambler who most commonly engages in it, but may be pursued with a fair chance of profit by the speculative investor who has a bank balance behind him. A stag is a person who applies for an allotment in new issues, with a view to immediate resale at a profit. Usually he applies for much more stock than he could possibly pay for, and if his allotment is in full—that is, if he gets all that he applies for—he has to sell out at once, before instalments begin to fall due. Consequently, if, owing to some accident, the issue is not successfully placed, and the stock is quoted at a discount,* his mere neediness and inability to

* New issues are almost invariably paid up by gradual instalments. You pay, for example, 5 per cent. on application, 15 per cent. on allotment, and the balance in four instalments of 20 per cent., each at intervals of two months. Until a stock is fully paid up it is usually quoted at so much premium, or so much discount, on the amount paid up on it. For instance, if 20 per cent. has been paid up, and the quotation is $\frac{1}{4}$ discount, this means that 19$\frac{3}{4}$ is the price; if the quotation is $\frac{1}{4}$ premium, 20$\frac{1}{4}$ is the price. If it is quoted at par, 20 is the price.

follow up his game compel him to face a loss. But the speculative investor, having resources at his back, can be a stag with more chance of success, because he can wait, paying up the instalments as they fall due, until the merits of the stock have asserted themselves. If he is careful only to apply for really good stocks that he is quite ready to hold if he cannot make an immediate profit by selling, he cannot break many bones, and he may fairly often take a nice profit. But stagging is a very dangerous game to the impecunious, for even if the stag sells his allotment at once, he can, in the case of ordinary industrial issues, only sell for special settlement, that is, for a date, which is fixed by the Stock Exchange Committee, when bargains in the new security are first settled. Sometimes the interval between the appearance of the issue and the special settlement is a long one, and in the meantime the stag, though he may have sold at a profit on paper, has to pay up any instalments that fall due. This was the unhappy plight of many operators who early in 1910 found the process of applying for new rubber shares so profitable at first. In the case of large and important issues, it is generally possible for the stag to sell his allotment for immediate cash, but thereby, of course, he gets a lower price than he can secure by selling for special settlement.

Those who make money out of speculation, or

speculative investment, are the privileged folk who really know all about the securities that they handle, and can tell what the companies which the securities represent are doing, to an extent that is impossible to those who have to depend on published reports, traffic returns, and the other announcements by which the general public is from time to time informed. With real information of this kind at his disposal, and with plenty of money at his command, to enable him to carry an operation through until calculations have become facts, and facts have dawned on the stock-buying public, this specially endowed kind of speculator can increase his capital with practical certainty, and sometimes very rapidly. But he is not of the general public. With the help of a good broker the general public can sometimes follow in the footsteps of the specially informed operator, and by searching for securities of which the growing merits have not yet been recognized, gradually acquire a holding of stocks which is pleasing to contemplate. But the preceding pages have been written in vain if they have not shown that stocks and shares and market movements are a weltering chaos of uncertainty and haphazard guesswork, based on figures that often mean nothing —or worse than nothing, because they seem to mean so much—and on gusts of opinion blown hither and thither by causes which have no logical

connection with the merits of the stocks affected. Whoso is wise will ponder these things and try to be a real investor, exposing himself as little as possible to speculative anxieties and pitfalls.

CHAPTER XIII

TWENTY-SEVEN YEARS AFTER

STOCKS and Shares are very much, in 1937, what they were in 1910, when this book was written. There has been very little change in the classes of securities, or in methods of dealing and transfer, or in the reports and accounts with which shareholders are mystified. The Stock Exchange, however, has considerably improved the service that it provides for the public. The Committee now exercises much more vigilant supervision over the securities that it allows to be dealt in or quoted, and the criticism of its attitude towards its duties in this matter, contained in the last pages of Chapter VIII, has lost much of its force. Moreover, brokers and dealers apply in these times much more intelligence and research to supplying themselves and the public with information concerning the position and prospects of securities. An intelligence department, stuffed with all the relevant statistics concerning companies and industries and all the influences that may affect the course of business,

is now part of the furniture of all up-to-date Stock Exchange offices, and is often managed or assisted by some one with a training in economic theory. The war, that shook us all out of our Victorian complacency, has sharpened the brains of the House almost as much as those of British industry.

Important changes have also been made with regard to the admission of new members. They are now obliged to acquire three Stock Exchange shares, and the three sureties (or two in the case of applicants who have served as clerks) are liable to the extent of £500 each if default happens within four years from admission, though this liability is modified in amount and duration when clerks are becoming members. The question whether the surety would accept the applicant's cheque is no longer asked ; but the sureties have to make a much fuller statement concerning their knowledge of the applicant, confirming his own description of his qualifications, and saying that from their personal knowledge they are satisfied as to his fitness, both financially and in all other respects, to become a member.

In other respects the old story is still mostly true. In fact, it is amusing to find that in 1910 I was voicing the opinion of thoughtful members to the effect that the " ideal merchant jobber," strongly backed financially and ready to take stock thrown out by the public and to be short when

it rushes to buy, was "largely a figure of the past." This same complaint has so often been repeated during the difficult months of 1937 and is evidently a hardy perennial!

But in investment policy and the attitude of the public and its financial advisers towards classes of securities there has been a profound and momentous change. In 1910, expressing what I believed to be the opinion of the experts best qualified to judge, I wrote, in Chapter XI, on the Real Investor, in a manner that implied that ordinary shares were not quite respectable, and should be regarded as "the speculative sauce which seasons the investment salad." Such was, in fact, the common belief in those days; and though it is again amusing to find that in pre-war days I was pointing out that high taxation and the high standard of extravagance and ostentation had caused many old investment conventions to be thrown into the dustbin, the prestige of fixed-interest securities and especially of Government obligations was still maintained. In this connection it is far from amusing to find that I could once say that "repudiation or default by a nation is most unlikely, because nations simply cannot afford to repudiate or default." Now practically all the debtor nations, headed by Great Britain, have suspended payment on part of their debts; and even America, the creditor of all the world, has repudiated the obligation of the gold

clause, when, without the smallest excuse, she devalued her dollar.

In pre-war times, however, and especially in the Victorian era, Government securities and other well-secured fixed-interest stocks were thought to be the only respectable investments, and purchases of common stocks and shares were regarded as necessarily speculative and therefore dangerous. This belief had been encouraged by the remarkable steadiness which fixed-interest securities had shown during the greater part of half a century from 1847 to 1896, with a strongly upward tendency towards the close of the period. During that period, the rate of yield on Consols, then representing the bulk of the British debt, hovered, in spite of many severe crises, between 3 and 3½ per cent. In 1888 the yield dipped below 3 per cent., and Mr. Goschen thereupon brought in his celebrated conversion scheme by which the rate paid on Consols was reduced first to 2¾ and afterwards to 2½ per cent. In 1896 Consols touched 114. With this long period of steadiness, followed by a rapid upward movement, it was small wonder that Consols were regarded by investors as a security in which they could have the most perfect confidence, and that those who could not afford the luxury of holding the very best, stuck largely to other trustee stocks and fixed-interest securities, which had followed the fortunes of Consols at a respectful distance.

This sentiment was slightly shaken by the relapse in security prices, moderate as it was, that followed the rise in commodity prices in the last years of last century, accompanied by the multiplication of trustee stocks, by the inclusion of colonial loans and the expenses of the Boer war, but the yield on Consols did not get back to 3 per cent. until 1907, and the prestige of Government securities and other trustee stocks was maintained until the war.

During the war this prestige was knocked to pieces. Consols went below fifty and the yield consequently soared above 5, and their holders who had bought above par saw their capital cut in half, while the income from them, though punctually paid, was paid in money which had lost half its purchasing power owing to the rise in the cost of living, to say nothing of the terrific rise in the rates of direct taxation. During this period, so disastrous for *rentiers*, they saw holders of ordinary shares in industries that benefited by the war pocketing greatly increased dividends.

This contrast, bringing home to investors the weakness of fixed-interest securities in times when the cost of living is rising, was the foundation of the revolution in investment fashion, which now recognizes much more fully the merits of ordinary shares and stocks, or "equities," as they are commonly called. In such times, while the holders of fixed-interest stocks, however well secured, receive no

more than the money income due to them and find that the money gives them less purchasing power, the possessor of ordinary shares is likely to be receiving higher dividends, because rising commodity prices are usually associated with periods of active and prosperous business. Moreover, it was found that the speculative streak in ordinary shares can be largely eliminated, if they are held in sufficient number to bring in the law of averages.

This doctrine of equities as the safest form of investment was preached in America by Mr. E. L. Smith in a book called " Common Stocks as Long Term Investments," published in 1925. Mr. Smith was President of an American investment company and had conducted a series of investigations, comparing the relative safety, from the point of view both of income and of capital, of a holding of a collection of common stocks and of a group of high-grade bonds. He found that over a long period of years, as tested by experimental investments in the two classes, the equity holders had fared much better than the bondholders ; and he laid his finger on the reason why. This is the fact that the directors of carefully managed companies never pay out as dividends the whole of the profits earned, but always (except of course in exceptional circumstances) put away something to reserves and invest this increasing fund in further profit-earning. This policy, consistently carried out,

means that the property and income of the company, which is that of the ordinary shareholders after prior charges have been met, rises steadily, subject to the fluctuations of trade which the reserve fund policy enables them to face.

American conditions were, of course, exceptional, owing to the rapid growth of the country's population and industries before and during the war; and a similar test, applied to British companies, was evidently needed before Mr. Smith's doctrine could be adopted with confidence by British investors. This was supplied by Mr. H. E. Raynes, a Fellow of the Institute of Actuaries, in a paper read before it in 1927, entitled "The Place of Ordinary Stocks and Shares (as distinct from Fixed Interest-bearing Securities) in the Investment of Life Insurance Funds." Since Insurance companies are noted for the caution and skill with which they conduct their investments, the mere fact that ordinary shares were considered a fit subject for the Institute's deliberations was a symptom of a change in sentiment on the subject.

Mr. Raynes gave the result of an investigation that he had carried out, by making an imaginary investment in 1912 of £54,000 in ordinary shares and of a similar amount in fixed-interest securities. The companies that he chose were those with the largest capitals in the list printed in the Investor's Monthly Manual, provided only that they were

dividend payers. By this purely mechanical method of selection he avoided all danger of choosing in the light of later experience—" jobbing backwards " as they call it on the Stock Exchange.

The money invested he divided among nine groups of securities—British Railways, British Electrical and Power companies, British Gas companies, Iron, Coal and Steel companies, Land Finance and Mortgage companies, Shipping, Telegraphs, Financial Trusts and Textile and allied. He took the six biggest companies in each group, and put £1000 into the ordinary stock or shares of each and £1000 into the fixed-rate securities (debentures, or preferences if there were no debentures) of the same concerns. The investment was imagined to have been held from March, 1912, to March, 1927, a period which covered the war, the after-war boom and slump, and probably some of the effects of the coal strike and general strike of 1926.

The result of this investigation of past experience was strongly in favour of ordinary shares. Mr. Raynes had calculated the income on his imaginary investment after deduction of income tax, which had risen rapidly during the war. In spite of this, the income from the holding of ordinary shares rose from £2964 for 1912 to £3531 for 1926, while that from the prior charges, owing to the rise in income tax, declined from £2134 to £1783. As to capital value, while the ordinary shares, originally

bought for £54,000, had risen to over £80,000, the fixed-interest stocks had fallen to £42,588.

Mr. Raynes drew the conclusion, firstly that nothing could be more convincing than this result as to the merits of spreading investments over a wide area, and secondly that "from the point of view of safety the figures indicate that a well-spread investment in ordinary shares is a better proposition for the ordinary long-term investor than an investment in the debenture issues of the same group of companies." A captious critic might pick holes in this investigation on the ground of the period chosen, which was favourable, on the whole, to equities, while fixed-interest stocks were depressed by the huge creation of Government debt involved by faulty war finance—too much borrowing and too little taxation. But a later investigation, the results of which he put before the Institute of Actuaries in a paper read in April, 1937, gives a comparison of the results from the two classes of securities in a period covering the unprecedented trade depression of 1929 to 1932, and therefore highly unfavourable to the equity holder. Nevertheless, during the ten years 1926 to 1936, the aggregate income received by him exceeded that of the fixed-interest holder by £457, and the capital value of the equities on January 1, 1937, was £7,742 higher than that of the fixed-interest stocks.

He also, like Mr. Smith, called attention to the

general policy of adding to reserves, as accruing to the advantage of equity holders, and further pointed out that the process of evolution in industrial organization is continuous, manifested in the growth of the size of the industrial unit and the interlocking of interests, which also tend to the greater security of the ordinary shareholder.

There is thus seen to be good practical reason for the modern preference for equity holdings, at least as part of a judiciously selected investment portfolio. But it should be noted that all these investigations were based on the principle of a widely spread holding. Any single ordinary share is still to some extent speculative, and only a bunch of them can, thanks to the law of averages, be regarded as an investment. The necessary spread was only possible for those who had, like the Insurance companies, large sums to invest, until the advent of the Unit Trust movement enabled the most modest capitalists to acquire a diversified holding of industrial equities.

This clearer recognition of the merits of ordinary shares, when well spread, as investments and the development of a movement which has put a well-spread holding of them within the reach of capitalists of modest means, together with the practical closing, since the recent depression, of the international capital market, are important changes in the outlook of investors.

GLOSSARY.

Account.—The process by which Stock Exchange bargains are settled. In most markets it occurs twice a month and lasts three days. Also called the settlement. The name Account is also used to express the period between two accounts.

Account-Day.—The last day of the Stock Exchange account on which stock is delivered and paid for, and differences are paid. Also called pay day or settling day.

Allotment.—(1) The distribution of a new security among subscribers to the issue, or (2) the portion of a new security received by a subscriber.

Asset.—An item on the credit side of a balance-sheet, showing some property or investment or debt held by a company as a set-off against its liabilities.

Backwardation.—A rate paid by a bear to enable him to renew a bargain until a later settlement.

Bear.—An operator who sells stock, which he does not mean to deliver, with a view to re-purchase at a profit.

Bearer Securities.—Bonds or shares the possession of which is in itself evidence of ownership. They are transferred by delivery.

Bonds.—Securities, generally "bearer," representing debts, either of companies or communities.

Book-Debts.—Sums standing in the books of a company or firm, representing debts due to it.

Brokers.—Members of the Stock Exchange who buy and sell securities for the public, acting as intermediaries between it and the jobbers, who provide the market.

Bull.—An operator who buys stock, for which he does not mean to pay, with a view to reselling at a profit.

Carry-over.—The process by which speculative bargains are continued from one account to another.

CARRY-OVER DAY.—The first day of the Stock Exchange account on which speculative bargains are continued.

COMMISSION.—The charge made by stockbrokers to clients for dealing in securities.

CONTANGO.—A rate paid by a bull, to a moneylender or a bear, to enable him to renew a bargain until a later settlement.

COUPON.—A detachable portion of a bearer security that is cut off and presented when interest is due or a dividend is payable.

COVER.—See Margin.

CUMULATIVE dividend or interest, means that arrears of it, if any, from previous years have to be met before anything is paid on securities ranking after.

DEALERS.—See Jobbers.

DEBENTURES.—Securities, generally "bearer," representing the debts of companies. Debenture stock is inscribed or registered.

DEFERRED Stocks and Shares are (1) sometimes formed by splitting ordinary stock into preferred and deferred, the preferred carrying a fixed dividend, and the deferred taking the balance of profit. (2) Deferred shares are sometimes another form of founders' shares (which see), or (3) sometimes take the final balance of profit after the ordinary, which then becomes practically a preference, has had a fixed rate of dividend.

DIFFERENCE.—The amount due to or from speculative operators on the occasion of a Stock Exchange settlement. It is arrived at by the difference between the price at which the bargain was entered into, or last carried over, and the making-up price at the current account.

FACE VALUE.—The nominal value of a stock or share as opposed to its market price. The face value of a £5 share is £5, though its price may be 30*s.* or £15. The face value of a partly paid share is the amount paid up—if it be a £1 share, 5*s.* paid, face value is 5*s.*

FLOATING DEBT.—In the case of a Government, temporary borrowings in the form of treasury bills, etc. In the case of a company, temporary borrowing in the shape of loan from bankers, bills payable, sundry creditors, etc., as opposed to more permanent debt on debentures and debenture stocks.

Founders' Shares.—Shares taken or subscribed for by the vendors or promoters; they generally take half the profits after the ordinary shares have received a certain rate of dividend.

Givers.—Bulls who want to carry over stock, and give the contango rate.

Goodwill.—The right to use the name and connection of a firm or company.

Guaranteed Stock or Shares.—Securities on which Interest is guaranteed to be paid, usually before the preference and ordinary receive any dividend.

Inscribed Stock.—Stock, the holders of which are enrolled in a list; it is transferable by the personal attendance of the holder, or his attorney.

Jobbers.—Members of the Stock Exchange who compose the various markets in it, and buy and sell from and to the brokers, who act for the outside public. Also called dealers.

Letter of Regret.—The form by which those who are bringing out a new issue inform applicants that they are unable to allot to them any of the stock applied for.

Liabilities.—The items on the debit side of a balance-sheet, showing the sums that a company or firm has to account for to its shareholders or partners, or pay to its creditors.

Liability, on a share or stock that is not fully paid up, is the amount for which any shareholder is liable if called on. The shares of the Law Guarantee Trust and Accident Society were £10 shares, on which £1 had been paid up, and the liability was thus £9.

Liquidation.—The process by which the property of a company is sold up, and the proceeds distributed among its creditors and shareholders.

Making a Price.—The naming of a double quotation by a jobber, who is prepared to buy at the lower or sell at the higher price, and makes the price before he knows whether he will be asked to buy or sell.

Making-up Price.—The official price at which speculative bargains are carried over at each account. It roughly represents the market-price current at noon on carry-over day.

MARKING A BARGAIN.—The process by which the prices at which bargains are done are included in the official record, which is put up on the Marking Board in the Stock Exchange and printed in the Official List.

MARGIN.—The difference between the market price of a stock and the amount that a moneylender will advance on it. If a stock is quoted at par and a banker will lend £950 on £1000 of it, the margin is 5 per cent. Also called cover.

NAME DAY.—See Ticket Day.

OPTION.—A right to buy or sell a security at a price during a certain period. (1) Subscribers to new issues are sometimes given an option which enables them to call for shares in the issuing company at par or some other stated price. (2) An option can be bought in the market, giving the holder the right to "call," that is, buy, or "put," that is, sell, a stock or share at a price during a stated period; or a double option can be bought, giving the holder the "put and call" for a period. This system limits the possible loss of the speculator, but the sum paid for the option is against his chance of profit.

ORDINARY Stocks or Shares.—Securities that take the balance of profit, subject to deferred shares, if any, after the debenture and guaranteed interest and preference dividends have been paid.

PAR.—When a stock or share is quoted at par the market price is the same as the face value, which see. In the case of stock par is £100; in that of a £1 share, £1; in that of a £1 share, 10*s*. paid, 10*s*.

PREFERENCE OR PREFERRED Stocks or Shares.—Securities carrying a right to dividend before the ordinary.

PREMIUM.—(1) Until they are fully paid up, new issues are quoted at so much premium above, or discount below, the amount paid up on them: ¼ premium on a bond that is 50 per cent. paid, means 50¼. (2) New securities are sometimes issued to the public at a premium, that is to say, for a price higher than their face value. If a company issues £10 shares at £2 premium, it sells them to the public at £12. In such a case the amount of the premium, less expenses of the issue, is usually carried to reserve fund.

PUT AND CALL.—See Option.

REGISTERED SECURITIES.—Securities the holders of which are enrolled in a list; they are transferable by deed.

SCRIP.—Generally, all forms of bearer securities. Particularly, a bearer certificate representing a new issue, until the definitive bonds, or store certificates, have been got ready.

SETTLEMENT.—See Account.

SHARE.—A portion of a company's capital, expressed in definite amounts and usually indivisible.

SINKING FUND.—A fund set apart by a Government or company for the redemption of debt or the writing down of assets. In the case of the British Government the fund is composed of (1) the Old Sinking Fund representing a surplus of revenue over expenditure; (2) the new Sinking Fund representing the difference between the amount set apart each year for the total Debt Charge, and the interest on the Debt.

SPECIAL SETTLEMENT.—The date appointed by the Stock Exchange Committee on which bargains in new securities are first settled.

STAG.—An applicant for a new issue, who applies with a view to prompt re-sale.

STOCK in a general sense means any kind of security dealt in on the Stock Exchange; more particularly a form of debt or capital which is divisible into, and transferable in, odd and varying amounts, and is always registered or inscribed.

SUBVENDOR.—The seller of a property to the vendor, the seller who disposes of it to a company.

TAKERS-IN.—Bears, or moneylenders, who are prepared to carry over commitments for bulls, by taking in the stock that the letter do not wish to pay for.

TICKET.—A document giving the name, etc., of the buyer of registered securities; it is passed on to the seller's broker, and enables him to draw up the deed of transfer.

TICKET-DAY.—The second day of the account on which tickets are passed. Also called Name-Day.

TURN OF THE MARKET.—The margin in favour of the dealer, provided by the double Stock Exchange quotation. He buys

at the lower and sells at the higher price, and so is generally able to cover the bargain at a profit.

VENDOR.—The seller of a business or patent or concession to a company which is being formed to work it.

WAITERS.—Stock Exchange officials, stationed at various points in the House to call members, to shout for members who are wanted, etc.

WRITING-DOWN.—The process by which the value of assets, as stated in a balance-sheet, is reduced to a level conforming to their realizable price.

WRITING-OFF.—Writing down a worthless asset to nothing.

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PRINTED IN GREAT BRITAIN BY
WILLIAM CLOWES AND SONS, LIMITED, LONDON AND BECCLES.